

Legislative Audit Division

State of Montana



Report to the Legislature

November 2003

Performance Audit

The Petroleum Tank Release Compensation Fund

Petroleum Tank Release Compensation Fund Board
Department of Environmental Quality

This report provides findings and recommendations relating to a performance audit of the Petroleum Tank Release Compensation Fund (Petrofund). Recommendations include:

- ▶ Redefining the Board's role to reflect a more proactive management approach.
- ▶ Revising the Board's membership, staff resources and appeals procedures.
- ▶ Improving the compliance, cleanup and compensation functions performed by the department and the Board.
- ▶ Transitioning coverage of petroleum release liability from Petrofund to private sector insurers.

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November 2003

The Legislative Audit Committee
of the Montana State Legislature:

This is our performance audit of the Petroleum Tank Release Compensation Fund (Petrofund). Petrofund is financed by a tax levied on distribution of petroleum products. The fund pays for cleanup of releases from petroleum storage tanks. Petrofund is administered by the Petroleum Tank Release Compensation Fund Board. The Department of Environmental Quality is responsible for regulation of underground tanks and release cleanup, and also provides administrative support to the Board.

This report provides information to the legislature regarding the solvency of Petrofund. To improve management of liabilities and fund solvency, we make recommendations for redefining the role of the Board, improving department operations, and addressing the future of Petrofund. Written responses from the Board and the department are included at the end of the report.

We wish to express our appreciation to all the Board members, department staff, and private individuals in the regulated community for their cooperation and assistance during this audit.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Scott A. Seacat", with a large, sweeping flourish extending to the right.

Scott A. Seacat
Legislative Auditor



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Legislative Audit Division

Performance Audit

The Petroleum Tank Release Compensation Fund

**Petroleum Tank Release Compensation Fund Board
Department of Environmental Quality**

Members of the audit staff involved in this audit were Tom Cooper,
Angie Grove, and Angus K. Maciver.

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Appointed and Administrative Officials

**Department of
Environmental Quality**

Jan Sensibaugh, Director
Tom Livers, Deputy Director

Remediation Division

Sandy Olson, Division Administrator

**Petroleum Tank Release
Compensation Fund**

Terry Wadsworth, Executive Director

**Petroleum Tank Release
Compensation Fund Board**

Barry Johnston, Chair
Daniel Manson, Vice Chair
Greg Cross
Gary Basso
Frank Schumacher
Terry Cosgrove

Introduction

The legislative Audit Committee (LAC) requested a performance audit of the Petroleum Tank Release Compensation Fund (Petrofund) and regulation of underground storage tanks (UST). Petrofund was established by the Montana legislature in 1989 to pay for allowable costs associated with releases from petroleum storage tanks and is funded through a tax levied on distribution of petroleum products. Fund administration is a joint responsibility of the Petroleum Tank Release Compensation Fund Board (the Board) and the Department of Environmental Quality (DEQ)

Program Funding

Petrofund has three programs associated with its operations; compliance, cleanup and compensation. The compliance program is funded primarily through tank registration fees and fees associated with permitting programs. Annual revenues from tank registration, licensing, and permitting fees are around \$330,000. The cleanup and compensation programs are funded through Petrofund. Annual fund revenues are around \$6.2 million. To date, Petrofund has paid approximately \$58 million in cleanup compensation.

Fund Solvency

The development of Montana's Petrofund was similar to the fund model used in many other states. Petrofund fulfills two functions:

1. **Compensation:** fund revenues are distributed as payments to eligible tank owner/operators undertaking cleanup of a petroleum release.
2. **Ability to Pay:** the fund provides the assurance required under federal and state law that the owner/operator has the financial ability to pay cleanup costs.

To fulfill these two functions, the solvency of the fund must be maintained, i.e., there must be sufficient monies present in the fund to meet financial obligations. For the compensation function, the fund should, on a continuing basis, contain sufficient monies to pay cleanup costs during any given time period. Over the last three fiscal years, the monthly average compensation payment was approximately \$500,000.

Report Summary

Ability to pay involves maintaining a reserve capacity to cover liabilities. Federal regulations (40 CFR 280.93) and Montana statute (section 75-11-307, MCA) define the annual aggregate liability limit for most tank owner/operators at \$1 million. Because Petrofund can be used by all eligible tank owner/operators in the state, there is a high level of exposure to potential loss.

The Trend Towards Insolvency

Since FY 1997, Petrofund posted a negative fiscal year-end fund balance on one occasion. For four out of seven years, the fiscal year-end balance was below \$1 million. The fund balance has declined in two stages driven by operational deficits in FY 1992 and 1993, and again in FY 1995, 1996, and 1997. Failure to arrest the trend towards insolvency could result in delays in compensation payments to tank owner/operators and could also adversely affect facility compliance status under federal/state ability to pay requirements. There could also be negative environmental and human health consequences if resources are not available for cleanup.

To safeguard solvency in the future, we are recommending changes in Petrofund management and operations. These recommendations should improve fund solvency through more proactive management and increased efficiency and effectiveness in Petrofund operations.

Board Duties and Responsibilities

Statute identifies the Board as the entity responsible for fund administration. The seven members are appointed for three-year terms by the Governor and include representatives from the petroleum industry and other private sector groups. We believe there are opportunities for the Board to play a more active role in managing liabilities and promoting fund solvency. To give the Board further direction, statute establishing the Board's role should be revised to reflect a proactive approach to managing liabilities. Following analyses of fund activity each biennium, the Board could report to the governor and legislature regarding the effectiveness of the fund and the need for changes to reduce exposure to liabilities.

Designated Petrofund Responsibilities

The board and the department are both involved in Petrofund eligibility determinations, cleanup, and compensation. Over the years, these roles and responsibilities became intermeshed between

the two entities. For example, Petrofund eligibility determinations are dependent on input from four different departmental entities, in addition to the Board. Cleanup and compensation review is dependent on opinions from staff in two different departmental units. Similarly, compensation approval is subject to a review by two department units, as well as approval by the Board.

The overlap of responsibilities has a detrimental effect on controlling costs and Petrofund liabilities. The negative impact is seen in two areas: (1) extensive timeframes for processing Petrofund compensation and (2) increased administrative costs. A number of these responsibilities should be reassigned.

Delegating eligibility responsibilities to Board staff should streamline the process and allow the Board to spend more time actively managing fund solvency.

The department should assign sole responsibility for cleanup action to a single entity. This responsibility should be separate and distinct from any cost estimate review or compensation determination. The department should also reassign compensation responsibilities from the Remediation Division to the department's Financial Services office. Reassigning compensation responsibilities should reinforce the functional boundary between cleanup and compensation.

Department compliance functions relating to UST permitting are assigned to the Remediation Division. The Remediation Division's process controls are focused on cleanup and are not well adapted to the compliance function. The benefits of reassigning UST compliance and permitting functions to the Permitting and Compliance Division include improvements in operational efficiency and program performance derived from the shared use of common resources and the accessibility of relevant expertise and experience.

Define and Standardize Corrective Action Procedures

Corrective action plans submitted to the department outline cleanup actions and associated costs. DEQ staff review and approve these plans prior to Petrofund compensation. In order to be eligible for compensation, owner/operators must initiate actions outlined in an

Report Summary

approved plan from the time of discovery until the release is resolved.

We found a wide range of formats and contents for corrective action plans. The lack of standardization appears to increase corrective action plan review time frames. Pre-defined remediation tasks should streamline the plan approval process by providing clear review parameters. Establishing a standardized format should also improve staff efficiency during plan review and reduce the length of time needed for corrective action approval.

Revise Petrofund Compensation Procedures

Following approval of a corrective action plan, the consultant or owner/operator can begin receiving compensation for the cost of cleanup. Compensation involves department staff reviewing and approving claimed amounts to ensure costs are reimbursable under the criteria defined in law. We found the department's approach to compensation does not ensure efficient or effective cost control. Staff determines reasonableness for individual invoice items on a time and materials basis rather than on a unit cost basis.

Funds in other states responded to the need for cost controls by developing unit costs for defined cleanup tasks and setting a maximum dollar value payable for the task. This is often referred to as a reasonable cost ceilings approach. Using a reasonable cost ceilings approach should reduce processing times for claims, department administrative costs, and claimant business costs.

The Board and the department agree on the necessity for moving forward with the implementation of reasonable cost ceilings. We believe the Board should establish a timetable for implementation of the new approach.

The Future of Petrofund

Petrofund was developed in response to specific circumstances. The fund's design and operation was determined by conditions which existed before federal regulatory efforts made a significant impact on the problem of petroleum releases. Petrofund was also developed at a time when financial assurance was unavailable or unaffordable in the private sector. Circumstances have changes.

At a basic level, the design of underground storage tanks has improved, reducing the risk of releases occurring. Improvements in technology do not necessarily lessen the severity of releases, but they do ensure fewer releases occur and reduce overall liability.

Changes in relation to compliance with federal and state requirements have also reduced release occurrence and liability. Compliance efforts resulted in 96 percent of tanks meeting all upgrade requirements and all USTs in the state are now subject to regular inspections. Due to the successful compliance effort, new releases are declining and appear to be stabilizing at around 50 per year. Petrofund has assumed liability for a large portion of historic contamination associated with petroleum releases.

As a result of these changes, private insurance coverage is now more available and affordable than before. The market for UST insurance has been growing as changes in tank design and state compliance efforts have reduced release risk and existing contamination has been mitigated by state fund activities. Previous barriers to purchasing UST insurance no longer exist.

Reducing the Tax Burden

The petroleum storage tank cleanup fee was originally set at \$0.75 per gallon and has remained at this level. As long as the state continues to assume liability, collection of the cleanup fee will be necessary. Transferring liabilities to the private sector would allow for the gradual reduction and eventual elimination of the tax burden resulting from financing release cleanup.

Making the Transition

Circumstances have changed since the early 1990s when state-sponsored financial assurance was the only option. We believe the Legislature should outline the steps to transition from Petrofund to private insurance coverage. Seven other states have already completed the transition to private insurance coverage or an alternative financial assurance mechanism in place of a state fund.

We believe tank owner/operators will find private insurance coverage the most suitable replacement for Petrofund, but statute

Report Summary

should continue to recognize other appropriate alternative financial assurance mechanisms. The timeframe for transition should be determined by the extent of Petrofund's existing liabilities. It is probable tax revenues will be required for 10 to 15 years to fund these liabilities. We also believe the legislature should consider options which will ease the transition into full private coverage, including an interim reinsurance/excess coverage program. By providing reinsurance for private UST insurers, the state can help to promote the development of a competitive market, while mitigating the impact of new premium costs for tank owner/operations.

Chapter I - Introduction & Background

Overview: This chapter provides introductory and background information relating to the Petroleum Tank Release Compensation Fund. The chapter also outlines our audit objectives and explains report organization.

Introduction

The Legislative Audit Committee (LAC) requested a performance audit of the Petroleum Tank Release Compensation Fund (Petrofund) and regulation of underground storage tanks (UST). Petrofund was established by the Montana legislature in 1989 to pay for allowable costs associated with releases from petroleum storage tanks and is funded through a tax levied on distribution of petroleum products. Fund administration is a joint responsibility of the Petroleum Tank Release Compensation Fund Board (the Board) and the Department of Environmental Quality (DEQ).

Background

Petrofund was established in response to environmental and health problems posed by accidental releases of petroleum products. When petroleum products (commonly gasoline, diesel or other fuel products) enter the environment, as either free product or vapors, they pose a threat to human and environmental health. In liquid form, these products can migrate across the surface or through soil to groundwater. Both petroleum liquid and vapors are highly flammable and present fire and explosive threats, particularly if they migrate through soils to enclosed spaces such as basements.

Federal and State Regulations

The original federal regulation of petroleum releases focused on underground storage tank (UST) systems. Petroleum products are also frequently stored in aboveground storage tanks (AST), but these pose a lesser release risk since equipment and leaks are generally visible. USTs are not only difficult to regularly inspect and monitor, they are also subject to corrosion and other structural failures which could result in a release. Federal regulations require these tanks meet certain design and construction standards to minimize release risk. Regulations also require the owner/operator of the tank

Chapter I - Introduction & Background

demonstrate the ability to pay for cleanup of any release from the tank.

In response to this federal regulation, many states established fund programs to pay for cleanup costs associated with leaking tanks. These funds also provide a means for owner/operators to meet the financial assurance requirements (the ability to pay for future releases). In most cases, states established a tax on the sale or distribution of petroleum products used to reimburse tank owner/operators for the costs of cleanup. Without a tax-financed program to provide compensation for cleanup, there was a risk owner/operators (gas stations) would either not report releases or would cease operations as a result of the cost.

Montana implemented various programs to ensure compliance with federal regulations. A UST compliance program ensured tank owner/operators met federal requirements before a December 1998 federal deadline. In addition to this tank compliance program, Montana established a program for regulating release cleanup through requirements for reporting and investigating releases. Montana also established the Petrofund to compensate owner/operators for the costs of cleanup. Although federal regulations focus on USTs, Petrofund is not restricted to releases from underground systems.

Compliance Function

DEQ's compliance program ensures tanks are registered annually with the department, tanks are subject to an inspection every three years, and installations, removals and other repairs or modifications are performed correctly by licensed contractors. The goal of the compliance program is release prevention.

Cleanup Function

DEQ also regulates release cleanup. If an owner/operator detects or suspects a release has occurred, they are required to notify the department within a defined timeframe and initiate cleanup action. Department staff monitors cleanup progress through a corrective action plan defining the extent of contamination and proposed cleanup actions. Cleanup can involve very simple measures such as

Chapter I - Introduction & Background

collection and disposal of liquid product from a minor surface spill. However, if contamination is more extensive or if groundwater is impacted, cleanup can be a complicated and costly process.

Compensation Function

Cleanup can involve substantial costs for the owner/operator of the tank. Petrofund is used to reimburse owner/operators for the costs associated with cleanup. The fund is administered by the Board with staff and other administrative support supplied by DEQ. The first step in the compensation process is an application for fund eligibility. Once a release is confirmed, the owner/operator can apply for fund eligibility. Eligibility requirements include tank compliance status, release reporting, cleanup progress, tank size, and tank ownership. Eligibility is determined by the Board based on the recommendation of department staff. If found eligible, the owner/operator can make claims for reimbursement of eligible costs incurred during cleanup. Claims are reviewed by department staff to ensure they meet the statutorily defined criteria of actual, necessary and reasonable. Based on the recommendation of department staff, the Board decides whether and when to pay claims.

Petrofund provides compensation of up to \$1 million per release. Tank owner/operators share in the cost of cleanup through a deductible of \$35,000, of which they are required to pay 50 percent. For most releases, the owner/operator pays a maximum of \$17,500.

Program Funding

The compliance program is funded primarily through tank registration fees and fees associated with permitting programs. Annual revenues from tank registration, licensing, and permitting fees are around \$330,000. The cleanup and compensation programs are funded through Petrofund. Annual fund revenues are around \$6.2 million. To date, Petrofund has paid approximately \$58 million in cleanup compensation.

Audit Objectives

Department officials and LAC members requested audit work focusing on the following areas:

- ▶ Strategies for strengthening fund solvency.

Chapter I - Introduction & Background

- ▶ Efficiency and effectiveness of the management structure.
- ▶ Department and Board compliance with applicable statutes.
- ▶ Methods for streamlining the fund eligibility and reimbursement process.

In response to this request, we established the following audit objectives:

1. Determine the factors influencing fund solvency and their potential impacts.
2. Evaluate the role of the Board.
3. Examine the effectiveness of the current management structure.
4. Evaluate the efficiency of fund eligibility and reimbursement procedures.
5. Provide the legislature information on potential fund management options.

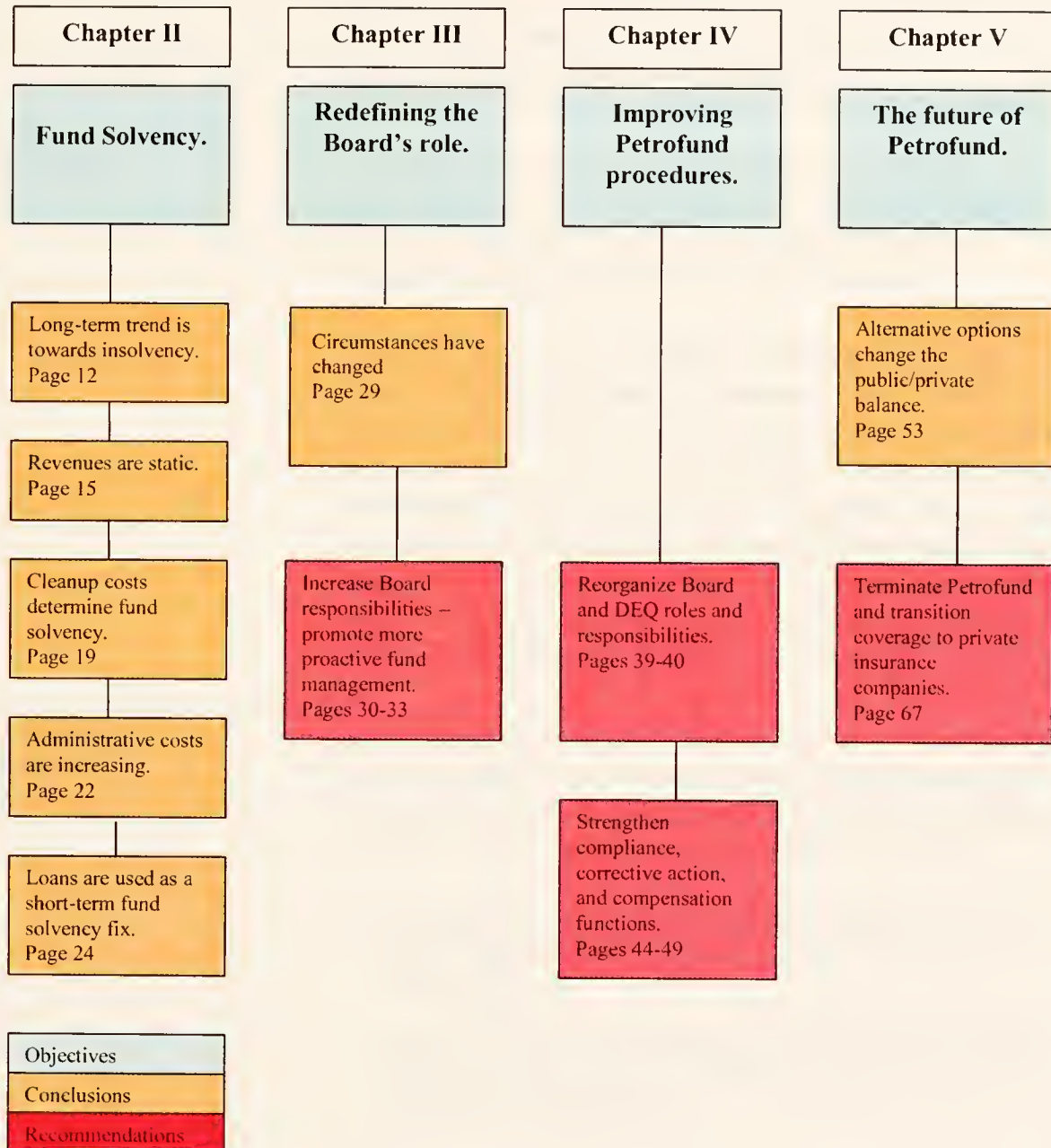
Audit Approach

Information on audit scope, methodologies, statutory compliance, management memos, and issues for further study are in Appendix A.

Report Organization

The organization of remaining chapters of this report is illustrated in the following figure.

Figure 1
Report Organization Overview



Chapter II - Fund Solvency

Overview: This chapter provides financial data and other information relating to Petrofund solvency. We conclude the long-term trend is towards insolvency. We also conclude cleanup costs are the primary cost driver of solvency and provide the major opportunity for managing fund liabilities.

Introduction

Our review of Petrofund solvency was guided by two audit objectives. First, determine which factors influence solvency and identify their impacts. Second, identify information on fund management options and their impact on fund solvency.

These two objectives address different aspects of fund solvency. The first objective relates to fiscal management of Petrofund and is concerned with specific circumstances and decisions, which resulted in fluctuations in the fund balance over time. Audit work focused on how different factors affected the ability to maintain solvency. This chapter addresses those factors. The second objective relates to the future of the Petrofund model. Audit work included a review of the purpose of Petrofund and the role of the Board in managing solvency. These issues are addressed in Chapter III.

Why is Solvency Important?

In 1989, Montana established Petrofund and financed it through a tax levied on distribution of petroleum products within the state. The development of Montana's Petrofund was similar to the fund model used in many other states. Petrofund fulfills two functions:

1. **Compensation:** fund revenues are distributed as payments to eligible tank owner/operators undertaking cleanup of a petroleum release.
2. **Ability to Pay:** the fund provides the assurance required under federal and state law that the owner/operator has the financial ability to pay cleanup costs.

To fulfill these two functions, the solvency of the fund must be maintained, i.e., there must be sufficient monies present in the fund to meet financial obligations. For the compensation function, fund

Chapter II - Fund Solvency

solvency is relatively easy to define: the fund should, on a continuing basis, contain sufficient monies to pay cleanup costs owner/operators incur during any given time period. Over the last three fiscal years, the monthly average compensation payment was approximately \$500,000.

Ability to pay involves maintaining a reserve capacity to cover liabilities. For insurance companies operating in Montana, the law requires a certain portion of policy premiums are kept in reserve to protect the fund against large losses. Petrofund is not regulated as an insurance company, but assuming liability for the cost of cleanup can result in the fund sustaining large 'losses'. Federal regulations (40 CFR 280.93) and Montana statute (section 75-11-307, MCA) define the annual aggregate liability limit for most tank owner/operators at \$1 million. Because Petrofund can be used by all eligible tank owner/operators in the state, there is a high level of exposure to potential loss. For this reason, Petrofund should retain the ability to meet the minimum liability of \$1 million at any given time.

Current Petrofund Solvency Status

Fund solvency is dependent on the relationship between fund revenues and expenditures. Solvency is maintained when revenue collected exceeds disbursement of expenditures. The solvency of the fund is threatened when the reverse is true. Table 1 shows financial data for fiscal years (FY) 1994 through 2003. These years cover the consecutive period of time when tax revenues were collected. Revenues, expenditures and the operating surplus or deficit is shown for each fiscal year.

Table 1
Petrofund Revenues and Expenditures
FY 1994-2003

Fiscal Year	Revenues	Expenditures	Operating Surplus/Deficit
1994	\$5,112,778	\$4,451,825	\$660,953
1995	\$5,901,318	\$6,575,865	(\$674,547)
1996	\$5,976,383	\$6,666,230	(\$689,847)
1997	\$6,027,123	\$9,541,933	(\$3,514,810)
1998	\$6,107,359	\$5,075,154	\$1,032,205
1999	\$6,183,626	\$5,499,461	\$684,165
2000	\$6,428,345	\$6,640,671	(\$212,326)
2001	\$6,319,922	\$7,178,434	(\$858,512)
2002	\$6,268,612	\$7,481,647	(\$1,213,035)
2003	\$6,333,824	\$5,328,196	\$1,005,628

Source: Compiled by the Legislative Audit Division from SABHRS and department records.

Expenditures exceeded revenues in six of ten fiscal years. For the life of the fund, expenditures exceeded revenues by approximately \$300,000. This operational deficit does not necessarily mean Petrofund experienced negative fund balances during this time. Accumulations of surpluses from previous years allowed the fund to maintain a positive FY-end fund balance in all but one year.

Chapter II - Fund Solvency

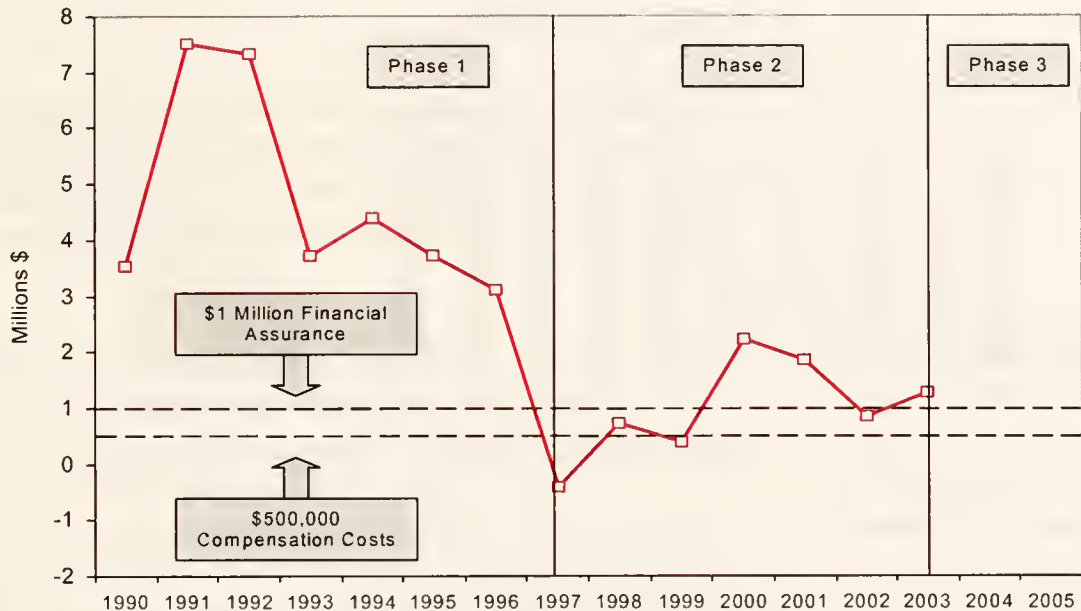
Fund Evolution

Review of the Petrofund from its early stages through FY 2003 allows us to identify three phases of fund evolution:

- ▶ Phase 1 (1990-1997) – releases were reported in increasing numbers from 1990 through 1995 as owner/operators upgraded systems to comply with regulatory requirements. As cleanup began, compensation and staffing to support the fund increased. Revenues remained static or grew slowly during this first phase, resulting in a declining fund balance. At the end of FY 1997, the fund closed with a negative fund balance. The 1997 legislature revised statute to allow the Board to borrow money.
- ▶ Phase 2 (1997-2003) – loans combined with a fall in the number of releases stabilized the fund balance. However, following a three-year decline, there was a sharp increase in releases in 1998-99. The cycle seen previously in phase 1 was repeated, leading to a declining fund balance.
- ▶ Phase 3 (2003) – another loan combined with a decline in both releases and compensation stabilized the fund balance going into FY 2004. It is unclear if this stabilization represents the start of a trend or a temporary phenomenon.

Figure 2 illustrates these phases based on year-end fund balances.

Figure 2
Petrofund Year-End Fund Balance
FY 1990-2003



Source: Compiled by the Legislative Audit Division from SABHRS and department records.

Operational Deficits and the Trend Towards Insolvency

Since FY 1997, Petrofund posted a negative FY-end fund balance on one occasion. For four out of seven years, the FY-end balance was below \$1 million. During phase 1, the fund balance declined in two stages driven by operational deficits in FY 1992 and 1993, and again in FY 1995, 1996, and 1997. The fund balance then increased during the first half of phase 2 as operational surpluses were recorded for FY 1998 and 1999. However, the upward movement in the fund balance was temporary and the long-term trend was renewed as operational deficits were again recorded in FY 2000, 2001, and 2002. Petrofund's ability to meet its obligations as a provider of financial assurance was impaired as the declining fund balance reduced the fund's reserve capacity. Petrofund's ability to pay compensation costs was affected in the same way, although to a lesser degree.

Conclusion: Operational deficits drive the decline in the fund balance. Declining fund balances reduce the availability of funds to act as reserve capacity, diminish Petrofund's financial assurance capabilities and, over the long term, jeopardize the solvency of the fund.

To further review the decline of the fund balance, we examined Petrofund revenues and expenditures. Information and conclusions on fund revenues, expenditures, and the use of Board of Investment loans between FY 1990 and 2003 is presented in the following sections.

Fund Revenue

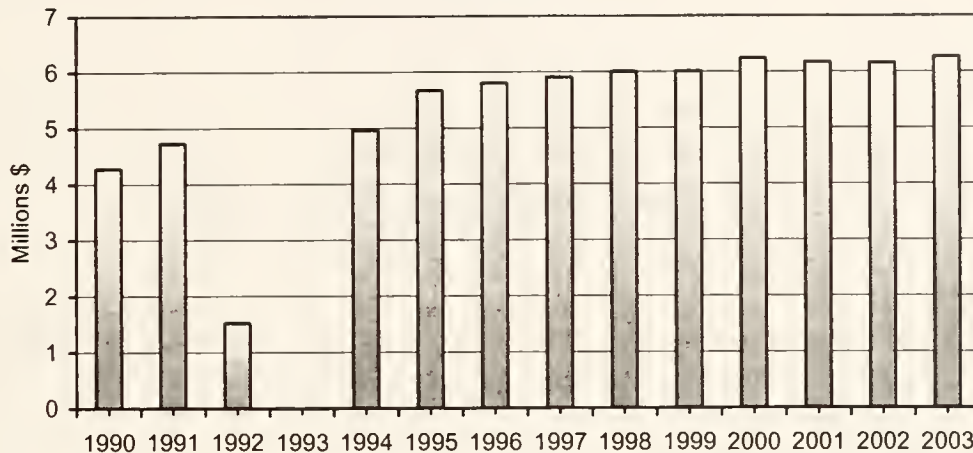
The primary source of fund revenue is the petroleum tank cleanup fee. This is supplemented by interest earned by the fund and miscellaneous revenue derived from various sources.

Petroleum Tank Cleanup Fee

The petroleum tank cleanup fee is established by section 75-11-314, MCA, as a general use fee of \$0.75 per gallon on refined petroleum products distributed within the state. Petroleum products subject to the fee include gasoline, diesel, aviation gasoline, special fuel and heating oil. The Montana Department of Transportation Fuel Tax Management and Analysis Bureau collects the fee and transfers monthly receipts to DEQ. The cleanup fee is collected through the same mechanism used for the gas tax, and the administrative costs associated with collection are absorbed by the Department of Transportation.

Collection of the fee is statutorily dependent on the Petrofund balance: if the un-obligated balance of the fund exceeds \$8 million the fee is suspended, and is only reinstated if the balance falls below \$4 million. This occurred in fiscal years 1992 and 1993 and explains the large drop in revenues during this period. Figure 3 shows trends in cleanup fee revenues for the period 1990 through 2003.

Figure 3
Annual Petroleum Cleanup Fee Revenues
FY 1990-2003



Source: Compiled by the Legislative Audit Division from SABHRS, DEQ, and MDT records.

The cleanup fee generated \$4.2 million in revenues in the first year of collection. Aside from the period when collection was suspended, revenues derived from the fee increased steadily as consumption of petroleum products increased and peaked in FY 2000 at \$6.2 million. Fee revenues dropped slightly in FY 2001 and 2002 but remained around \$6.2 million. Department of Transportation projections for fee revenue over the next seven fiscal years show past trends continuing and point to modest annual increases resulting in approximate annual revenues of \$7.2 million by FY 2010.

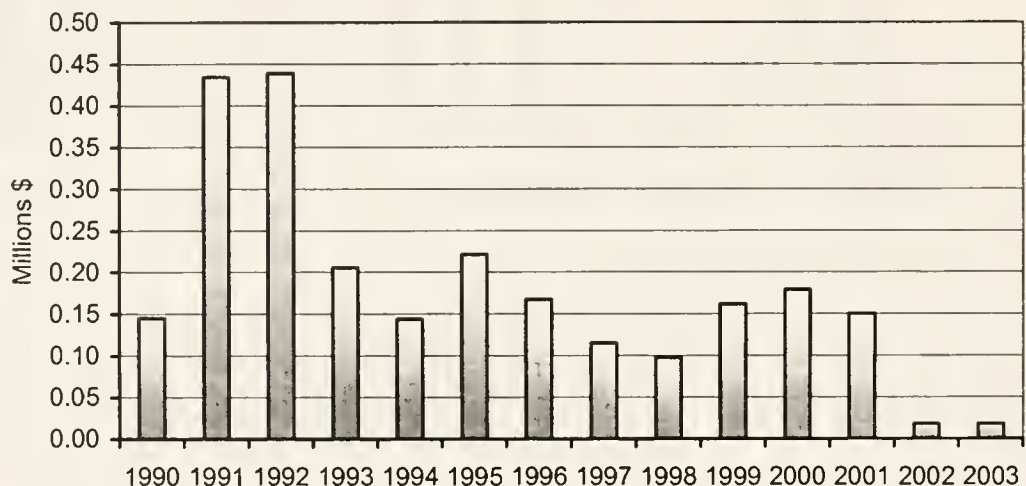
Earned Interest Revenue

A secondary source of revenue is derived from investment earnings generated by Petrofund. Funds, which are not immediately needed to meet obligations, are used to purchase investments through the state's Short Term Investment Pool. The amount of revenue earned is dependent on two factors: the level of funds available and the interest rate paid. The amount of un-obligated funds has decreased, resulting in fewer dollars available for investment. Combined with declining rates of return due to the unfavorable investment

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environment, the result is a considerable drop in short-term investment revenue since FY 2000. In the early 1990s, interest revenues peaked at over \$400,000 per year. Since then, interest earnings have declined to around \$20,000 per year. This decline is illustrated in the following figure.

Figure 4
Annual Petrofund Earned Interest Revenues
FY 1990-2003



Source: Compiled by the Legislative Audit Division from SABHRS and department records.

Miscellaneous Revenue

An additional revenue source for Petrofund is miscellaneous one-time revenue. One-time revenues have not made a significant contribution to the fund. The main source of these revenues was legal settlements, which accounted for approximately \$140,000 out of \$150,000 in miscellaneous revenue since 1990.

Revenue Summary

Petrofund is primarily dependent on revenues from the cleanup fee. In FY 2003, the cleanup fee generated 99 percent of fund revenues. Although the cleanup fee proportion of fund revenues has not always

been so large, overall the fee has constituted 96 percent of total fund revenues (investment earnings and miscellaneous revenue contributed a further 4 percent). Revenues derived from the cleanup fee are likely to continue following present trends – revenue has been static or growing at a slow annual rate over the past 12 years.

Conclusion: The primary source of revenue for Petrofund is the petroleum tank cleanup fee. Revenues derived from the fee are likely to remain static or continue growing at a slow rate in the future.

Fund Expenditures

Section 75-11-313, MCA, states Petrofund may be used for three purposes:

- ▶ Compensation – expenses associated with payments made to owner/operators who have submitted claims for cleanup costs.
- ▶ Administration – expenses incurred by the Board or the department as part of administration of the fund.
- ▶ Loan repayment – repayment of the principal and interest charges for loans advanced by the Board of Investments.

We provide information on the use of Board of Investment loans in a separate section. The following sections provide information and conclusions on compensation and administration expenditures.

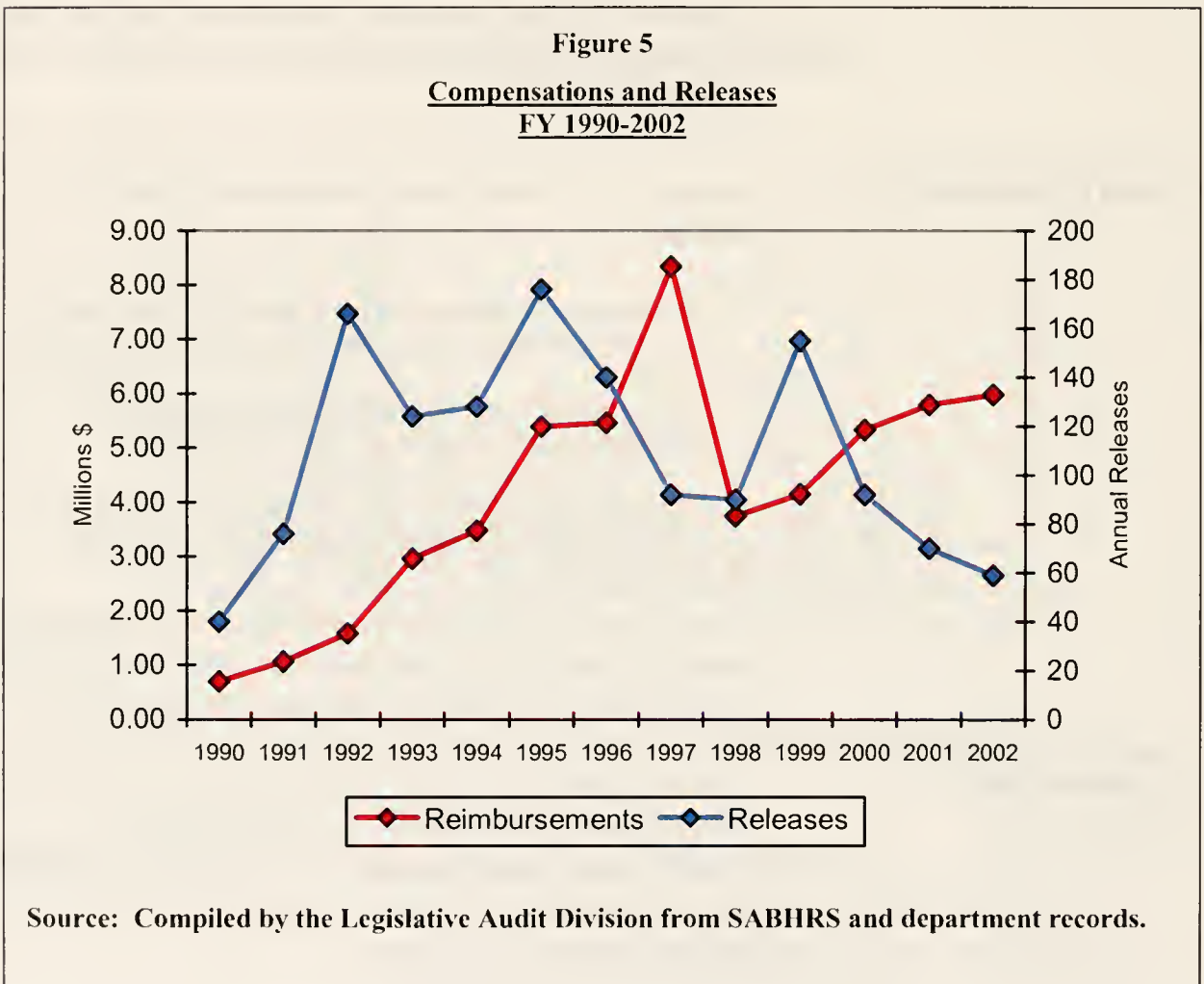
Compensation for Cleanup Costs

The major expenditure category is compensation to owner/operators for costs associated with cleanup. For eligible releases, owner/operators request compensation for cleanup costs. Following a review, adjustment, and approval process, payment is made either in whole or in part.

The volume and dollar amount of Petrofund compensation payments varies according to the number, types, and complexity of releases. As the number of releases rise and cleanup begins, compensation from the fund also increases. Annual compensation expenditures have been increasing since the start of the program and peaked in

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FY 1997 at \$8.4 million following a steady rise in the preceding six years. Compensations then dropped in FY 1998 to \$3.7 million before beginning another upward trend from FY 1999 to 2002, and then declining in FY 2003. Figure 5 shows compensation expenditures (left axis, red line) and petroleum releases determined eligible for the fund (right axis, blue line).



The most noticeable feature in this figure is the illustration of the relationship between the number of releases and compensation expenditures. The number of releases peaks three times. These peaks are associated with the various regulatory deadlines

established for tank equipment upgrades. Releases were discovered as tank sites were excavated for upgrading. Compensation peaks are also evident, occurring two to four years after the earlier release peak.

- ▶ The first release peak occurs in 1992 and is followed by a drop in the number of releases. Compensation costs rise through the early 1990s before stabilizing in 1995-1996, three years after the first release peak.
- ▶ The second release peak occurs in 1995 and is also followed by a decline in the number of releases. Two years after this second release peak, compensation costs increase in 1997 to peak at around \$8 million.
- ▶ The final release peak occurs in 1999 and is followed by a decline in the number of releases to present levels. Compensations follow the trend and begin to increase between 1998 and 2002, although the increase is more gradual than seen previously.

Compensation expenditures are determined by the number of releases identified and determined eligible for the fund. Since the number of releases has declined since 1999 and past trends suggest a lag between releases and compensations, costs should have or have already peaked at around \$6 million per year and are now likely to decline. However, it is possible trends will not follow established patterns and may be affected by the different cleanup characteristics of releases discovered towards the end of regulatory deadlines.

Quantifying the Cost of Existing Cleanup

Establishing an accurate figure to reflect existing liabilities of the fund is a problem. Since 1986, approximately 4,000 releases have been reported to the department. Of these, approximately 2,500 have been resolved, leaving around 1,500 active releases. But not all these releases are Petrofund-eligible. Releases may be refused eligibility due to statutory exemptions or compliance violations. In some cases, the owner/operator elects to self-fund cleanup rather than apply to Petrofund. In other cases, contamination does not pose a threat to the environment or human health and the release can be resolved without recourse to the fund. Compensation for

Chapter II - Fund Solvency

approximately 1,400 eligible releases has been paid to date, resulting in expenditures of approximately \$58 million. Of these, over 650 have been resolved and over 740 are unresolved releases. To quantify the fund's existing liability, it is necessary to calculate how much more money will be spent on cleanup for the 740 unresolved, fund-eligible releases. The following list highlights the range of estimates compiled from various sources.

- ▶ Data from the 2002 State Fund Administrators Survey shows a national average cost per closed release of around \$77,600. If this average holds true for the 1,400 Petrofund releases, total expenditures could exceed \$100 million. This suggests an existing liability of around \$50 million.
- ▶ In 2002, department staff estimated the existing liability for unresolved, fund-eligible releases. Staff reviewed past expenditures for each release, assessed progress on cleanup and estimated the remaining costs. The estimates show the fund has a total existing liability of approximately \$78 million.
- ▶ Petrofund data shows the average cost for resolved releases is around \$12,500, significantly lower than the current average for unresolved releases (around \$72,700). Department staff suggests the releases which have been resolved were less complex and the remaining releases may be more difficult to resolve and may require more resources.
- ▶ There are approximately 300 reported releases less than five years old, which have not applied for eligibility, but could at some point in the future. There is no indication how many could be eligible for the fund, but the worst-case scenario suggests additional liability in excess of \$10 million.

To date, cleanup expenditures have exceeded \$50 million and, as noted above, could eventually total \$100 million or more. Even if existing liability is calculated at some level less than \$50 million, the fund will still require significant resources over the next ten years. Historically, release discovery is determined by the extent and timing of federally mandated regulation. Petrofund has little control over these regulatory activities. However, there are opportunities for controlling both the number of releases found eligible for the fund or the rate at which cleanup costs are paid. Controlling compensation

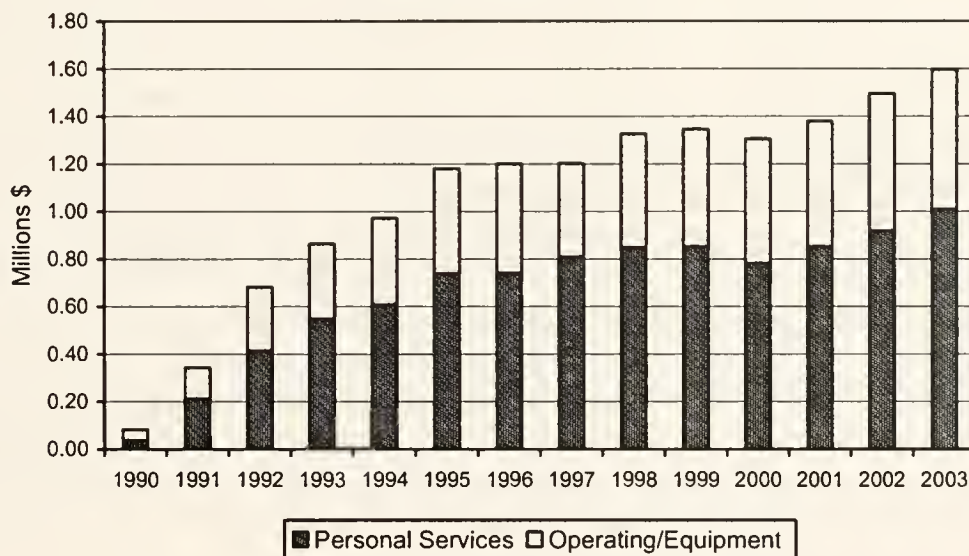
expenditures provides an opportunity for maintaining fund solvency over the long-term.

Conclusion: Compensation for cleanup is the primary factor altering fund solvency and provides the major opportunity for controlling costs and maintaining fund solvency.

Board and Department Administrative Expenses

Expenditures associated with administrative costs can be sub-divided to include personal services and operating/equipment costs expended by the department or the Board. Figure 6 shows trends in administrative cost sub-categories between FY 1990 and 2003.

Figure 6
Annual Expenditures for Administrative Cost Sub-Categories
FY 1990-2003



Source: Compiled by the Legislative Audit Division from SABHRS and department records.

Personal Services

Personal services expenditures consist of salaries and benefits for department and Board staff. Following initial increases, the rate of increase for personal services slowed. Expenditures were stable

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through the mid to late-1990s at around \$850,000 per year, decreased in FY 2000, and then increased in 2001, 2002, and 2003 by 8.8, 7.8 and 9.8 percent respectively. For fiscal year 2003, annual personal services expenses totaled \$1,008,330.10.

Operating and Equipment Expenses

Increases and decreases in operating and equipment expenses followed the pattern seen in personal services. Following initial increases, the rate of increase slowed and, apart from a 14 percent drop in FY 1996 and 1997, expenditures in this category tended to follow a slow, uniform rate of growth. For fiscal year 2003, annual operating and equipment expenses totaled \$588,254.77.

Administrative Costs Compared to Fee Revenues

The proportion of Petrofund monies used to cover administrative costs has been an issue of concern for tank owner/operators in Montana. Concern focused on the proportion of the fund used for administrative purposes compared with funds in other states. For our review, we defined administrative costs as all non-compensation expenditures (debt service charges are excluded). These expenditures cover not only the administrative processing of compensation claims, but also the costs associated with department regulation/supervision of cleanup. Unlike some other states, Montana funds regulation of petroleum releases using the cleanup fee. This approach results in higher administrative costs for Petrofund, but it ensures release regulation is adequately funded. We calculated the proportion as a percentage of revenue derived from the cleanup fee (short-term investments and miscellaneous revenues were excluded). Using this method, we calculated current Petrofund administrative costs at 25 percent of fee revenues. Table 2 shows administrative costs for FY 1994-2003.

Table 2
Annual Administrative Costs as a Proportion of Fee Revenue
FY 1994-2003

Fiscal Year	Administrative Costs	Fee Revenues	Percentage
1994	\$971,663	\$4,967,453	20%
1995	\$1,181,183	\$5,675,846	21%
1996	\$1,200,828	\$5,807,833	21%
1997	\$1,202,509	\$5,910,994	20%
1998	\$1,326,531	\$6,007,973	22%
1999	\$1,346,429	\$6,013,468	22%
2000	\$1,306,576	\$6,248,375	21%
2001	\$1,379,303	\$6,169,083	22%
2002	\$1,495,956	\$6,159,618	24%
2003	\$1,596,585	\$6,268,885	25%

Note: Data before FY 1994 is excluded due to suspension of cleanup fee collection.

Source: Compiled by the Legislative Audit Division from SABHRS and department records.

**Are Montana's
Administrative Costs
Excessive?**

Obtaining comparative information relating to the administrative costs of other state assurance funds is problematic. No two state funds function in the same manner, funding sources are different, compliance and regulatory authority varies widely, and costs are accounted for differently. Information from other states shows estimated administrative cost proportions vary from 7 percent to 36 percent. However, there appears to be no reliable basis for a comparison of Montana's administrative costs with those in other states.

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Administrative Costs are Increasing

Overall, administrative costs increased at an average annual rate of 6.5 percent, compared with an average annual growth rate for fee revenues of 2.8 percent. From FY 2000 to FY 2003, administrative costs rose from 21 percent to 25 percent of fee revenue. This increase can be explained by rising expenditures for Board activities and department administrative duties relating to compensation claim processing. Over the same period, fee revenues remained static. The difference between these annual average rates resulted in the growing proportion of revenues used to cover administrative costs. If administrative costs continue to grow at the historic average rate, they could constitute 32 percent of fee revenues by FY 2010. However, the department anticipates administrative costs will begin to fall as the number of reported releases declines.

Conclusion: When compared to fee revenues, administrative costs are increasing at a higher rate. As a consequence, a growing share of fund resources is being expended as administrative costs.

Board of Investment Loans

Section 17-6-225, MCA, provides authority for the Board of Investments to loan funds to the Board. The Board used loans on two occasions, in FY 1998 and FY 2003. Both loan amounts were approximately \$1 million and are repayable over ten year terms. The fund currently makes two loan repayments each fiscal year, consisting of principal and interest. To date, debt service charges made up 1 percent of total fund expenditures.

First Loan Application

A 1996 performance audit identified fund solvency concerns and projected a zero fund balance during calendar year 1997. This projection was based on a review of fund revenues, compensation and other expenditures from previous years. While this projection represented a worst-case scenario, it provided warning of the deficit.

Legislation authorizing the Board to borrow money was passed during the 1997 legislative session. Early in FY 1998, the Board applied for and received a loan of \$1.2 million from the Board of

Investments. The decision to use loans to address fund solvency appears to have been based on two considerations:

- ▶ In May 1997, the Board entered into a legal settlement with an owner/operator seeking compensation for third-party damages. Under the terms of the settlement, the Board agreed to secure a Board of Investments loan in sufficient amount to make a lump sum payment of \$1.5 million.
- ▶ Loans provided a means to maintain a positive cash balance and continue making compensation payments.

Loans Used a Second Time

In FY 2003, the Board applied for a second loan. The Board agreed to a line of credit totaling \$2.5 million and the first loan draw was for \$1 million. To date, no additional draws have been made against this line of credit. Again, the decision to apply for a loan appears to have been based on two factors. As identified in the FY 2001 and 2002 Financial Compliance Audit report (report number 02-14, issued December 2002), department cash monitoring and management procedures resulted in Petrofund experiencing negative cash balances. The second factor was the same problem experienced in FY 1998: rising cleanup costs resulting from a peak in releases.

The Costs of the Loan Strategy

To date, the fund has expended approximately \$250,000 in interest payments on the two loans (repayment on the FY 2003 loan began in February 2003). We projected future costs for servicing this debt until both loans are repaid in FY 2013. Our projections show total interest costs for both loans will be approximately \$550,000 by FY 2013.

Loan Repayment Summary

There have been two occasions in the life of Petrofund when rising cleanup costs, compounded by short-term circumstances, accelerated the trend towards insolvency. In the first case, although the Board had knowledge of impending problems, the scale of the obligation imposed by the legal settlement restricted options. A loan was necessary given these circumstances. In the second case, short-term factors also came into play. However, by FY 2003 the Board had knowledge of the likely negative impact on the fund of the release

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peak observed in 1998-99. There was a four-year window of opportunity available to make changes to the fund and allow continued operations without threatening solvency. The Board did not take advantage of this opportunity. Despite the clear trend in compensation costs from 1998 through 2002, the fund solvency issue was not addressed until the cash balance fell below zero. Our projections show the second loan will result in additional costs to Petrofund of \$240,000 over the next ten years.

How do Loans Impact Solvency?

Montana law allows Petrofund to borrow up to a maximum of \$15 million. Although loans cover temporary cash shortfalls, they have been used to mitigate the long-term fund solvency problem. Given that loans are likely to impose an extra liability of around \$550,000 on Petrofund, it is questionable whether they are an effective means of promoting fund solvency. In addition, access to loan revenue appears to have had the effect of restricting consideration of alternative fund management options.

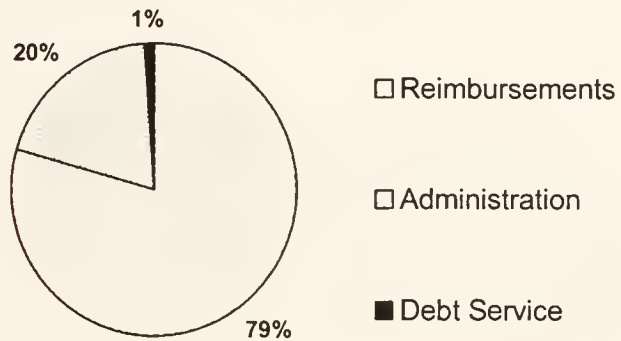
Conclusion: The use of Board of Investments loans has imposed additional liabilities on the fund, allowing a short-term fix (solvency) but resulting in long-term consequences (extra liability).

Fund Solvency Summary

Compensation for cleanup, over the life of the fund, constituted approximately 79 percent of total fund expenditures. Administrative costs accounted for 20 percent of total fund expenditures. An additional 1 percent of expenditures are debt service costs. Figure 7 shows how total fund expenditures since 1990 were divided between different expenditure categories.

Figure 7

**Expenditure Categories as Proportions of
Total Petrofund Expenditures
FY 1990-2003**



Source: Compiled by the Legislative Audit Division from SABHRS and department records.

At 79 percent of total expenditures, compensation for cleanup is the primary factor affecting Petrofund solvency. While increases in administrative costs contributed to the decline of the fund balance, reducing expenditures in this category has a marginal impact on fund solvency. Significant reductions in administrative costs would be difficult to impose without adversely affecting the state's ability to regulate petroleum releases and compensate owner/operators.

Failure to arrest the trend towards insolvency could result in delays in compensation payments to tank owner/operators and could also adversely affect facility compliance status under federal/state ability to pay requirements. There could also be negative environmental and human health consequences if resources are not available for cleanup. In addition, the use of loans imposed additional liabilities which will need to be met through tax revenues. To safeguard solvency in the future, we are recommending changes in Petrofund management and operations. Recommendations in Chapter III address change in the management approach of the Board.

Chapter II - Fund Solvency

Recommendations in Chapter IV relate to the functional role and responsibilities assigned to the department. These recommendations should improve fund solvency through more proactive management and increased efficiency and effectiveness in Petrofund operations.

Chapter III - Redefining the Board's Role

Overview: This chapter addresses the Board's role in managing fund liabilities. To improve fund solvency, the Board should proactively manage fund liabilities and make changes in its operations and procedures.

Introduction

Prior to federal regulation of underground storage tanks in the mid-1980s, tanks were largely unregulated. The requirements that owner/operators pay for cleanup and demonstrate ability to pay for future releases created a liability of at least \$1 million for every tank. Private insurance companies offered liability coverage for existing risks, but the creation of a new class of liability increased premium costs. Insurers were reluctant to assume liability for tanks in poor condition. In some cases, insurance companies declined to write policies covering underground storage tank release liability in any circumstances. Petrofund provided a solution to the problem by using tax revenues to cover the cost of cleanup.

Circumstances Have Changed

In relation to the establishment of Petrofund, section 75-11-301 (3), MCA, states:

“The legislature finds that the current administrative and financial resources of the public and private sectors are inadequate to address problems caused by releases from petroleum storage tanks and need to be supplemented by a major program of release detection and corrective action.”

This statute identifies three issues as important justifications for the fund: the need for a release detection program; the need for a corrective action program; and the lack of resources in the public and private sectors to finance and administer these programs.

- ▶ **Release Detection Program.** The department initiated an underground storage tank compliance program to ensure all tanks in the state were either upgraded or closed. The compliance effort resulted in the permanent closure of approximately 20,000 UST systems. Of the remaining 4,200 operating systems, 97 percent meet the 1998 upgrade

Chapter III - Redefining the Board's Role

requirements. Petrofund made a significant contribution to ensuring the success of the compliance program by providing incentives for owner/operators to report releases. Petrofund covered cleanup costs and enabled UST owner/operators to upgrade their tanks and stay in business.

- ▶ **Corrective Action Program.** Petrofund has paid \$54 million in corrective action costs. Due to the success of the compliance effort, the number of new releases has declined. Recent data shows releases stabilizing at around 50 per year. Of these, 50 percent appear to be the result of human error during product delivery or customer dispensing and are likely to be minor spills.
- ▶ **Financial and Administrative Resources.** The law defines several different financial assurance mechanisms which can be used as alternatives to a state fund, including private insurance, self-insurance, risk-retention group coverage, guarantee, bonding or letter of credit. Petrofund was established because other mechanisms were not adequate at the time. In 1990, the poor compliance status of many USTs and historic contamination made meeting ability to pay requirements virtually impossible for many tank owner/operators. The extent of the liability resulted in alternative mechanisms being unavailable or unaffordable for most. Developments in other states and in the private insurance market show alternatives are now available and affordable.

Petrofund was developed because the private sector could not finance cleanup. Petrofund has financed cleanup for over 1,400 releases achieved at significant cost in terms of expenditures and existing liability. Thirteen years of cleanup and additional regulatory requirements have had an impact. Most historical release sites have been reported and cleanup initiated. Current operating facilities are subject to more stringent compliance criteria intended to reduce the risk of a release. As a result of the success of the regulatory efforts, circumstances are now sufficiently different to justify a reassessment of the Board's role in managing fund liabilities and promoting fund solvency.

Conclusion: Circumstances have changed. Since section 75-1-301 (3), MCA, was enacted:

- ▶ Regulatory requirements have improved compliance.
- ▶ Historical site cleanup was initiated.
- ▶ Private sector alternatives are now available.

Board Duties and Responsibilities

Statute identifies the Board as the entity responsible for fund administration. The seven members are appointed for three-year terms by the Governor and include representatives from the petroleum industry and other private sector groups. The primary duties and responsibilities are outlined in section 75-11-318, MCA, as follows:

- ▶ Fund administration.
- ▶ Fund eligibility and compensation determination (includes obligation of funding to pay cleanup costs).
- ▶ Assignment of fund resources for department cleanup and compensation functions.
- ▶ Adoption of rules to administer the program.

Board Focus is Fund Administration

Statute assigning the Board responsibility for fund 'administration' has led members to focus on eligibility and compensation rather than long-term fund management. The consensus among members was because the fund's purpose is defined in statute, the Board cannot pursue alternative fund management options. As a result, the Board had not considered making recommendations to the legislature to pursue alternatives for managing liabilities and continues to focus on administrative functions.

One of the effects of this approach is annual expenditures typically match or exceed available revenue each year. As shown in Chapter II, operational deficits have resulted in a long-term trend towards insolvency. The Board focused on details of individual cases and fund liabilities. As a result, the declining fund balance went un-addressed. In two instances when sufficient revenue was

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not available, the Board decided to use loans from the Board of Investments instead of addressing the root cause of the problem.

Board Focus Should be Fund Management

We believe there are opportunities for the Board to play an active role in managing liabilities and promoting fund solvency. To give the Board further direction, statute establishing the Board's role should be revised to reflect a proactive approach to managing liabilities. Following analyses of fund activity each biennium, the Board could report to the governor and legislature regarding the effectiveness of the fund and the need for changes to reduce exposure to liabilities.

Recommendation #1

We recommend the Board adopt a proactive approach to management of fund liabilities by seeking statutory authority to revise its role to include analysis of fund activity and review of the fund's exposure to liabilities.

Additional Recommendations to Improve Management of Liabilities

To better manage fund liabilities, the Board should expand its expertise, designate staff responsibilities, and improve appeals documentation. These changes are addressed in the following recommendations.

Board Expertise

Examination of Board membership in 25 other states shows the types of experience and skills required of Montana's Board members is comparable to most other states, with one exception. We noted 23 of 25 states also require a member of a local, state or federal regulatory agency. As the Board expands its fund management role, we believe the membership could benefit from additional environmental regulatory expertise. Environmental regulation has a major impact on fund solvency. An in-depth understanding of how regulatory activities affect Petrofund should promote solvency. For example, consideration of topics such as site prioritization and closure, and regulation of above ground storage tanks could have important implications for fund solvency. A Board member with regulatory experience could provide insights relating to the impact of regulatory

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activities on cleanup costs. Therefore, membership requirements should be revised to include a representative with a background in environmental regulation.

We believe representatives from local government such as county sanitarians and officials from state and federal regulatory agencies, as well as members of the private sector with an appropriate regulatory background, should all be considered candidates.

Recommendation #2

We recommend the Board seek legislation to increase membership by including a representative with environmental regulatory experience.

Board Requires Staff Support to Manage Fund Liabilities

During the 2003 Legislative Session, passage of HB 368 provided the Board authority to hire its own staff. We believe this change should allow the Board to address other issues. We also identified three opportunities for improvements that could be developed and implemented as part of the duties of the new Board staff:

- ▶ **Projections for Future Liabilities.** To improve management of fund liabilities, the Board will require data projecting cleanup requirements and costs for active releases. In addition, the Board will require a methodology for projecting future releases and associated liabilities. The current liability projections available to the Board do not provide a sufficient basis for making valid projections. With better data, the Board can evaluate the impact of different fund management approaches more effectively.
- ▶ **Site Prioritization and Closure.** Existing law does not address the prioritization of releases for cleanup. Currently, all releases regardless of environmental or human health risk are eligible for compensation on a first come, first served basis. The Board is not able to make a distinction between high- and low-risk releases and cannot allocate resources accordingly. Until there is a clear picture of where cleanup funding should be concentrated, the Board will not be able to accurately assess the future direction of the fund.
- ▶ **Regulation of Aboveground Storage Tanks.** Aboveground storage tanks (AST) have not been subject to the same level of

Chapter III - Redefining the Board's Role

regulation as underground tanks. The compliance requirements for ASTs are less stringent than those for underground systems and aboveground tanks do not require regular inspections or licensing. As a result, the department and the Board do not have accurate data on the liability associated with releases from AST facilities. Petrofund continues to assume liability for AST releases, but does not have the means to quantify its extent or to mitigate future risks. In order to manage fund liabilities, the Board is the logical forum for developing recommendations relating to regulation of ASTs and coverage of cleanup costs by Petrofund.

Recommendation #3

We recommend the Board direct staff to conduct analyses and make recommendations on fund management issues including, but not limited to, the following:

- A. Future fund liability projections and methodology.**
- B. Site prioritization and closure.**
- C. Regulation and financial assurance for aboveground storage tanks.**

Improve Appeals Procedure Documentation

Based on concerns identified during the FY 2001 and 2002 Financial Compliance Audit (report number 02-14, issued December 2002), we evaluated Board decisions related to appeals of fund eligibility determinations. Board minutes show discussion between parties in attendance and Board members. The minutes also reflect the outcome of the eligibility vote. However, most minutes neither specify factors or evidence leading to the determination nor identify the criteria used in the evaluation. In some cases, we noted the testimony described in meeting minutes provided information warranting a Board decision different from DEQ staff. While this information was generally described in the minutes, there was no explanation of how the Board weighed the evidence and made a final decision in favor of fund eligibility.

Section 75-11-309 (2), MCA, lists Board decision-making criteria including the need to "affirmatively determine" eligibility. We

Chapter III - Redefining the Board's Role

interpreted the affirmatively determine language to require documentation of Board decisions. We do not believe the limited documentation reflected by meeting minutes meets the intent of the law. In addition, lack of adequate documentation creates the impression of a decision-making process, which is arbitrary and inequitable. If the Board has no sound basis for its decisions, its position as an independent and objective forum for appeals is compromised.

Board members suggested there may have been inconsistency in past decisions and were unanimous regarding the need to improve documentation of Board decisions in the future. To assure consistency, we believe section 75-11-309 (2), MCA, requires the Board to document the factors considered and how the Board made its decision. With such documentation available, cases can be compared for consistency and precedence established as appropriate. Establishing consistency in this process should promote a structured approach to managing and projecting the fund's liabilities.

Recommendation #4

We recommend the Board document the evidence considered and reasons for decisions relating to fund eligibility appeals.

Chapter IV – Improving Petrofund Procedures

Overview: This chapter addresses changes in Petrofund procedures to improve management of fund liabilities. We recommend the department and the Board reorganize roles and responsibilities relating to compliance, cleanup and compensation.

Introduction

In Chapter III, we addressed options for improving Petrofund solvency through changes in the Board's management approach. The Board shares responsibility for fund functions with the department. We have identified changes in three functional areas which could improve management of liabilities and fund solvency:

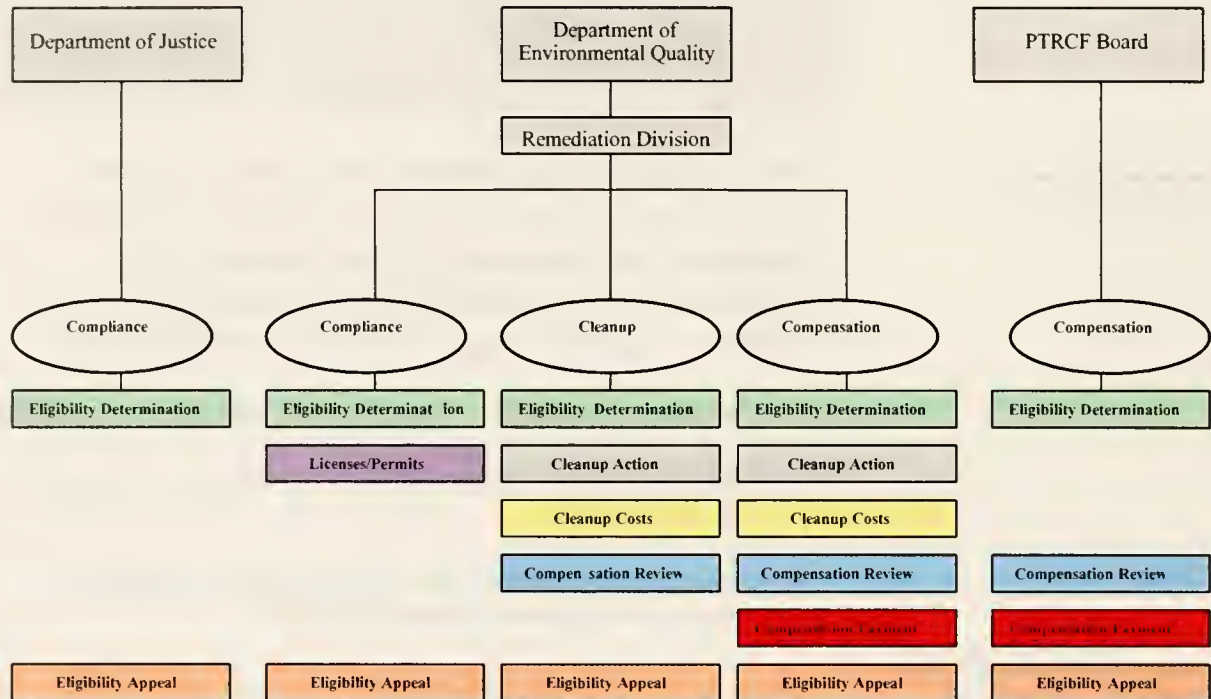
- ▶ Compliance Procedures. Streamline tank-permitting procedures.
- ▶ Cleanup Corrective Action. Define corrective action tasks and standardize plans.
- ▶ Cleanup Compensation. Revise cost controls to simplify processes and decrease resources required.

Designated Petrofund Responsibilities

The Board and the department are both involved in Petrofund eligibility determinations, cleanup, and compensation. Over the years, these roles and responsibilities became intermeshed between the two entities. Overlap also occurs within the department and between DEQ and the Department of Justice, which also has a role in compliance decisions through enforcement of fire safety standards. For example, Petrofund eligibility determinations are dependent on input from four different departmental entities, in addition to the Board. Cleanup and compensation review is dependent on opinions from staff in two different departmental units. Similarly, compensation approval is subject to a review by two department units, as well as approval by the Board. The payment process involves both department staff and the Board. Appeals of decisions can potentially involve five entities. Figure 8 shows the current organizational roles and responsibilities for Petrofund. Responsibilities are represented in the figure by color-coded blocks. Procedures are duplicated where blocks of the same color appear under multiple department entities.

Chapter IV – Improving Petrofund Procedures

Figure 8
Existing Petrofund Organizational Roles and Responsibilities



Source: Compiled by the Legislative Audit Division.

How Does Procedure Overlap Affect Petrofund Solvency?

The overlap of responsibilities has a detrimental effect on controlling costs and Petrofund liabilities. The negative impact is seen in two areas: (1) extensive timeframes for processing Petrofund compensation and (2) increased administrative costs. During review of Petrofund files, we identified extensive processing times for approving fund eligibility, corrective action plans, and cleanup compensation. The average processing time for an eligibility determination was 155 days. Corrective action review exceeded 30 days for 58 percent of the plans in our sample, failing to meet the 30-day processing timeframes established in law. In addition, compensation processing exceeded 30 days for 84 percent of the claims in our sample. The primary factor contributing to these timeframes was overlapping review.

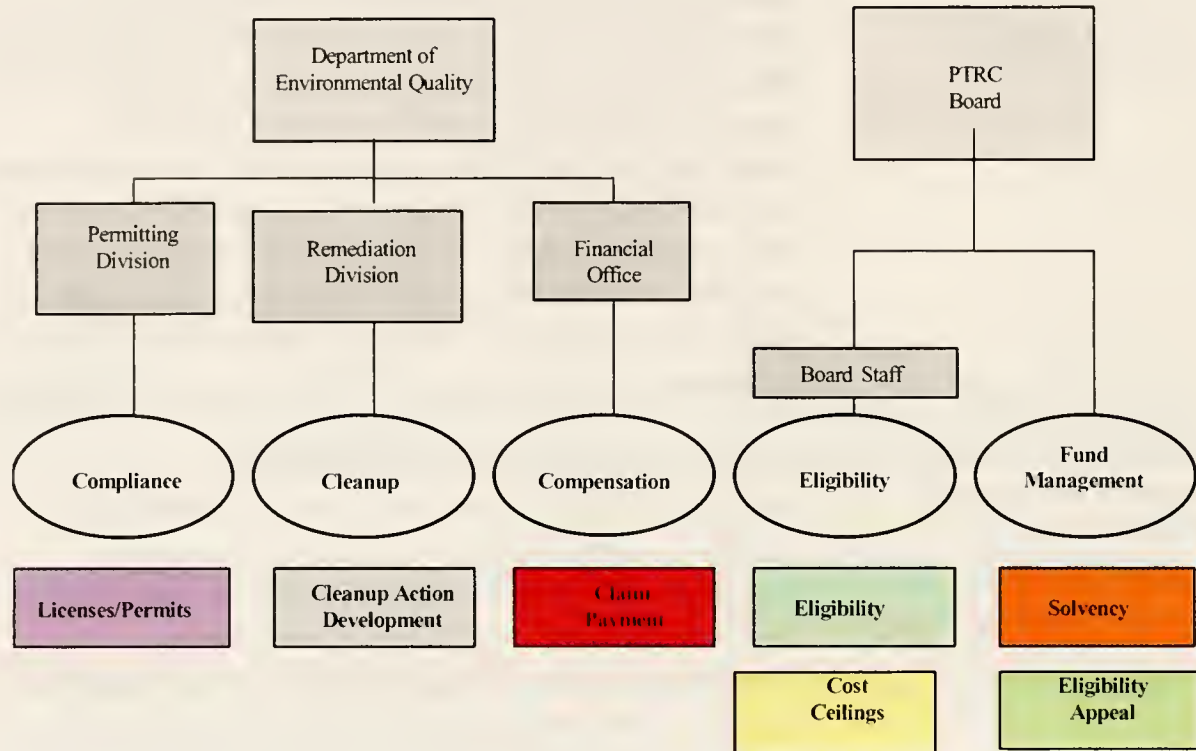
As procedures and processes become more complex and duplicative, administrative overhead costs increase. Annually, Petrofund expends \$1.4 million for administration of the fund and for administering environmental regulations governing petroleum releases. This duplication results in Petrofund sustaining unnecessary and avoidable administrative costs. Revisions of section 75-11-309, MCA, by the 2003 Legislature, switched responsibility for claims review and approval from the department to the Board. Our audit work indicates further clarification and re-assignment of Petrofund responsibilities is warranted to improve fund solvency management.

Streamlined Procedures Decrease Timeframes and Administration Costs

To reduce processing timeframes and provide an opportunity to re-evaluate administrative resource requirements, responsibilities should be reassigned. Figure 9 illustrates the recommended organizational roles and responsibilities following reassignment. These changes should consolidate functional roles and responsibilities into defined organizational units. By eliminating overlap, different entities should be able to focus on their own missions, allocate their resources more efficiently, reduce process timeframes, and realize savings in administrative overhead costs.

Figure 9

Recommended Petrofund Organizational Roles and Responsibilities



Source: Compiled by the Legislative Audit Division.

Use Board Staff for Fund Eligibility

The Board currently spends the majority of its time reviewing appeals and other administrative business with minimal impact on fund solvency. The 2003 Legislature revised the criteria for eligibility making it less complex and allowed the Board to hire its own staff. Using the less complex criteria, designated Board staff should be able to complete more timely eligibility determinations. Delegating eligibility responsibilities to Board staff should streamline the process and allow the Board to spend more time actively managing fund solvency. The Board would only be responsible for formal eligibility appeals requested by owner/operators.

Recommendation #5

We recommend the Board designate fund eligibility review and notification to Board staff.

Separate Department Cleanup and Compensation Functions

The responsibilities of various department entities in relation to the cleanup and compensation roles have become confused. Cleanup decisions should be made primarily on the basis of environmental/human health risk and should not be driven by fiscal considerations. The current dual review process threatens this separation, and increases process timeframes and administrative costs. The department should assign sole responsibility for cleanup action to a single entity. This responsibility should be separate and distinct from any cost estimate review or compensation determination. The department should also reassign compensation responsibilities from the Remediation Division to the department's Financial Services office. The office's emphasis on fiscal management and expertise in fund management, purchasing and procurement should allow for improvements in processing Petrofund compensations. Reassigning compensation responsibilities should reinforce the functional boundary between cleanup and compensation.

Reassign Department Compliance Function

The Permitting and Compliance Division is responsible for all of the department's permitting functions, with the exception of underground storage tank (UST) permitting. Compliance functions relating to UST permitting are assigned to the Remediation Division. The division's focus is reactive (remediation), rather than preventative. The Permitting and Compliance Division provides process controls focused on developing and maintaining effective permitting programs to assure compliance with regulatory requirements. The Remediation Division's process controls are focused on cleanup and are not well adapted to the compliance function. Our review of UST permitting programs identified concerns including extensive process timeframes, inconsistencies in compliance decisions, and a lack of effective oversight. The benefits

of reassigning UST compliance and permitting functions to the Permitting and Compliance Division include improvements in operational efficiency and program performance derived from the shared use of common resources and the accessibility of relevant expertise and experience.

Both the Board and the department concur with our review of organizational roles and responsibilities. The Board is currently reviewing its staffing needs in response to recent legislation and plans to incorporate implementation of our recommendations in this process. The department established a timetable for implementing the recommended organizational changes and plans to have some of this process completed by December 2003.

Recommendation #6

We recommend the department designate the following responsibilities:

- A. Cleanup review, approval and monitoring to a single department entity.**
- B. Compensation processing to the department's office of Financial Services.**
- C. UST permitting and compliance responsibilities to the department's Permitting and Compliance Division.**

Strengthening Compliance Procedures

As part of our audit, we examined regulatory functions performed by the department relating to the registration, inspection and permitting of underground storage tanks. DEQ's Remediation Division is responsible for ensuring underground tanks are installed, maintained and operated in compliance with applicable statutes and administrative rules. These compliance activities are similar in function to the underwriting activities of a private insurance fund. Underwriting is defined as the process for assessing insurance risks and pricing the accepted risks. Petrofund cannot reject risks and does not use premiums. However, department permitting programs can reduce the fund's liabilities by decreasing the potential releases

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occurring. Although compliance functions are separate from direct Petrofund management activities, they have traditionally played an important role in fund solvency and liability management. In the following section, we make recommendations intended to strengthen the department's compliance procedures and reduce liabilities for the Petrofund.

Permit May Not be Necessary for All Activities

Before installing, removing, repairing or modifying an underground tank, the owner/operator or their contractor must obtain a permit from the department. The permit application process does not make any distinction between different types of tank activities such as installation or repair. Therefore, the permits issued do not reflect the relative environmental risk and technical complexity of the work proposed. Program staff confirmed activities such as spill bucket repair or vent pipe extension are currently subject to permitting, but do not pose a significant environmental risk.

The broad statutory definition of the term "installation" results in the inclusion of almost all tank repairs and modifications as activities requiring permits. The definition in statute conflicts with the authority the department has to use administrative rules to exclude certain activities from permitting. By including low risk activities in the program, the cost to owner/operators, contractors and the department is increased, without any corresponding reduction in risk or fund liability. The department should seek statutory revisions to clarify its authority to exclude low-risk activities from permitting.

Target Use of Environmental Assessment Questionnaires

To ensure compliance with the Montana Environmental Policy Act, the department requires all permit applicants to complete an environmental assessment questionnaire. Staff time and resources are expended reviewing the questionnaire regardless of circumstances or necessity. For example, many USTs are fitted with a spill bucket to contain liquid leaking from the fill pipe during delivery. Repairing or replacing a spill bucket is considered a minor modification and poses virtually no risk to the environment. However, the contractor repairing or replacing the spill bucket needs

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to complete an environmental assessment questionnaire consisting of 35 questions as part of the permit process. Targeting questionnaire use to ensure it is only prepared in circumstances where an environmental review is warranted will reduce paperwork and save time for both contractors and staff.

Implement Oversight of the Operating Permit Program

The UST operating permit program was established by the 1999 Legislature. The program provides for third-party inspectors from the private sector to perform inspections of all operating underground tanks and submit a report to the department. The department uses the inspection report to determine compliance and issue a permit. Every facility must be inspected and obtain a permit every three years. The department historically has not conducted oversight inspections of permitted facilities on a regular basis. Staff indicated three or four oversight inspections have been performed since the inception of the program. Section 17.56.1403 (e), ARM, authorizes oversight inspections to verify accuracy of inspection reports submitted by private third-party compliance inspectors. Currently, the department's only means of oversight for the operating permit program is the paperwork review of all inspection reports received.

Our file review showed 21 percent of the reports reflect different compliance determinations (department staff compared with third-party inspectors), indicating potential problems with the conduct of inspections. For example, some inspectors made a positive compliance determination when required information was not available or was insufficient for compliance purposes. Without field oversight of inspections, compliance with regulatory requirements cannot be verified and the performance of inspectors cannot be assessed. Since tanks require an inspection every three years, we believe at least one oversight evaluation of each inspector should occur in the same timeframe. By implementing regular field oversight, staff could improve quality control of inspections, ensure the knowledge and skills of the inspectors are regularly assessed, and improve compliance with regulatory requirements.

Review Compliance Requirements for Fund Eligibility

Section 75-11-308(1)(e), MCA, requires compliance with applicable laws/rules for fund eligibility. Department and Board rules further define compliance to include elements of the 1997 Uniform Fire Code. To verify fire code compliance, staff coordinates with the Department of Justice, Fire Prevention and Investigation Bureau (FPIB), to request information about fire code inspections. This coordination process averaged 64 days, in some cases delaying Petrofund eligibility determination, and did not add value to the review. We found fire safety inspection information was available for only 8.5 percent of the 61 release site files examined.

As an alternative to the current procedure, we believe information about fire code compliance could be compiled during the UST operating permit inspection for underground storage tanks. Any fire code data obtained at that time would then be available to Board staff during eligibility review. This approach eliminates the need to coordinate with the Fire Prevention Investigation Bureau during a fund eligibility review. This recommendation does not involve an expansion of the department's regulatory role. Operating permit inspections should include documentation of available information. This information would not be used to determine compliance for the operating permit. However, it would provide Board staff information for fund eligibility decisions and would reduce process timeframes by eliminating the need to contact the FPIB.

The department concurred with those elements of this recommendation relating to its two permitting programs and has established timetables for implementation. The department has increased its oversight inspection schedule. As of October 1, 2003, the department had performed oversight inspections for all 36 licensed inspectors.

Recommendation #7

We recommend the department strengthen compliance procedures by:

- A. Seeking legislation revising section 75-11-203(6), MCA, to clarify the department’s authority to exclude low-risk activities from UST permitting.**
- B. Targeting the use of environmental assessment questionnaires during UST permitting.**
- C. Assuring department oversight of operating permit inspectors occurs at least once during a three-year operating permit inspection cycle.**
- D. Compiling fire safety compliance information as part of the three-year inspection cycle to reduce eligibility processing time frames.**

Define and Standardize Corrective Action Procedures

As defined in statute, corrective action means “investigation, monitoring, cleanup, restoration, abatement, removal, and other actions necessary to respond to a release.” Corrective action plans submitted to the department outline cleanup actions and associated costs. DEQ staff review and approve these plans prior to Petrofund compensation. In order to be eligible for compensation, owner/operators must initiate actions outlined in an approved plan from the time of discovery until the release is resolved.

Standardized Tasks and Report Procedures Would Streamline the Process

The department does not enforce standardized format requirements for corrective action plans. We found a wide range of formats and contents for corrective action plans. Some plans outline limited details on work tasks and provide bare-bones cost estimates. Other plans are hardbound, lengthy documents with extensive data relating to soil conditions, water tables, cleanup alternatives, and detailed cost estimates. Releases also have one corrective action plan covering all three phases of cleanup (remediation, cleanup, and monitoring). Other releases have multiple plans for different phases, which creates confusion during the compensation process when staff attempts to verify actual and necessary corrective action plan-

approved costs. Our file review and discussions with department staff indicated wide variances in plan formats and structure create problems throughout the corrective action process. It can be difficult to determine what tasks have been completed and which plan governs those tasks.

The lack of standardization appears to increase corrective action plan review time frames. A review of 61 random release files revealed an average department review time of 51 calendar days with 58 percent exceeding the 30-day time frame required by ARM. In addition, our survey of contractors and consultants showed only 39 percent thought the plan review process was timely. Pre-defined remediation tasks should streamline the plan approval process by providing clear review parameters. Establishing a standardized format should also improve staff efficiency during plan review and reduce the length of time needed for corrective action approval. The department is currently reviewing requirements for standardized corrective action plan formats and has established a timetable for implementing changes and making necessary revisions to administrative rules by April 2004.

Need for a Corrective Action Plan Should be Based on Release Risk

Although statutes and department procedures imply a corrective action plan is required for all releases, our file review identified 14 releases with no corrective action plan. Payments of \$107,894 were made on these releases. In some cases, it appeared these were simple releases where cleanup was addressed on the spot during a tank removal process and only one or two claims were submitted. In other cases, the releases were more complex and cleanup was more extensive and expensive.

Cleanup often occurs during the course of other scheduled work performed on a tank system. In these situations, the preparation and review of an extensive corrective action plan is not always an effective use of staff time/resources. Cleanup work performed in conjunction with other projects may not warrant a formal corrective action plan. We believe a release complexity determination and an

environmental risk evaluation should be used to establish the need for a formal corrective action plan and/or to determine when a formal plan is required. The department already conducts environmental risk assessments for all releases in the early stages of the cleanup process. The department plans to use this assessment as the basis for developing a risk-based approach to corrective action plans.

Formalize Approval of Corrective Action Plan Changes

Flexibility is also needed after a plan is approved because site complexities can change after cleanup is underway. File reviews identified a wide range in procedures and documentation for DEQ approval of these changes. Defined procedures have not been established to ensure approved changes in the scope or type of work are properly documented. Disputes often develop between the department and consultants directing release cleanup due to inadequate documentation of changes. In one example, a department decision to disallow costs was disputed by a consultant on the basis of an alleged phone conversation which took place six months previously. There was no documentation supporting the department or the consultant in this case. Our file review showed multiple methods are used to document changes in the type or scope of work, ranging from handwritten notes of telephone conversations, to formal, written amendments to corrective action plans.

It is generally recognized that on-site realities dictate the need for on the ground decision-making. Highway construction programs developed formal change order procedures to allow for this type of flexibility. Their process allows for contract amendments not anticipated during the project's planning phase. Defining the amendment process clarified expectations of both Department of Transportation staff and contractors/consultants. The DEQ is in the process of introducing amendment procedures for corrective action plans. These procedures have been developed in conjunction with remediation consultants and rulemaking will follow later this year.

Summary

Defining corrective action tasks strikes a balance by creating clear cleanup parameters, while allowing for flexibility to respond to site

and industry changes. Twenty-five other states have improved their corrective action process through the use of standard forms for corrective action plans. We believe DEQ can take similar steps to strengthen Montana's corrective action plan procedures. Improvements in this area could lead to better regulatory compliance thereby reducing Petrofund's exposure to liability.

Recommendation #8

We recommend the department strengthen corrective action procedures by:

- A. Defining corrective action tasks.**
- B. Standardizing plan formats.**
- C. Determining when a corrective action plan is warranted.**
- D. Establishing formal corrective action plan amendment procedures.**

Revise Petrofund Compensation Procedures

Following approval of a corrective action plan, the consultant or owner/operator can begin receiving compensation for the cost of cleanup. Compensation involves department staff reviewing and approving claimed amounts to ensure costs are reimbursable under the criteria defined in law. We found the department's approach to compensation does not ensure efficient or effective cost control. Staff determines reasonableness for individual invoice items on a time and materials basis rather than on a unit cost basis. For example, a task such as groundwater monitoring may claim individual costs for personnel, mileage, per diem, equipment, handling/shipping charges, and lab analysis. Each item cost must be separately assessed by staff, which results in extensive review time frames. File review showed an average total processing time of 121 days. Total processing time for compensation exceeded 30 days for 84 percent of the claims reviewed. This was further verified by a survey of Petrofund contractors/consultants. Only 40 percent thought the compensation process was timely.

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How do Compensation Procedures Affect Petrofund?

In reviewing files, we found adjustments of \$87,422 were made on requested compensation of \$2,020,098 (representing 4 percent of the total amount). The savings realized does not appear to warrant the amount of time expended by staff. For example, 60 percent of claims were adjusted for less than \$100 (representing only 3 percent of the total dollars), but slightly over 50 percent of the total dollar adjustment was accounted for by only 5 percent of claims. Five staff members are involved in completing this time intensive review. Retrospective adjustment of claims on a time and materials basis does not add value proportionate to the department/consultant time and effort involved. Establishing a formal project budget would allow the department to eliminate the adjustment process almost entirely.

Extended processing times impact fund solvency by increasing department administrative costs and ultimately reducing funding available for cleanup. Consultants and owner/operators are also affected by processing times. Because claims are submitted for costs already incurred, owner/operators or consultants rely on payment to cover expenditures and maintain cash flow in their businesses. Delays in processing compensation payments result in increased business costs. Without effective methods for establishing budgets, it is also difficult to project dollar impacts to the fund and tank owner/operators. Our file review showed claimed costs represent 123 percent of estimates. Efficient allocation of fund resources depends on predictable expenditures. This is also a problem for tank owner/operators. Without a reasonable expectation of project costs, the ability to monitor expenditures against budget, assess the consultant's performance, and secure value for money are all impaired.

How is Compensation Addressed in Other States?

Funds in other states responded to the need for cost controls by developing unit costs for defined cleanup tasks and setting a maximum dollar value payable for the task. This is often referred to as a reasonable cost ceilings approach. This approach first identifies

and characterizes a specific cleanup task identified in a corrective action plan, and, second, defines a cost or cost range to be applied to the task. For example, the task of monitoring well sampling would be characterized as including staff time, equipment, and sample storage, handling, shipping and analysis charges, necessary to produce an analytical result for one well. A cost or range of costs could be defined for the entire task or an individual component of a task to produce a maximum cost or range of costs. Ordinarily, Petrofund would not pay costs beyond this maximum level without further review. To date, 35 states have developed and implemented some form of reasonable cost ceilings.

Implementing Reasonable Cost Ceilings

The department initiated, but did not finalize or implement reasonable cost ceilings. The department's approach is based on examples from other states, but at this stage it is only a conceptual model. Considerable effort will be required to develop a cost control structure that meets the needs of Petrofund, the department, owner/operators, and contractors/consultants. The Board and the department agree on the necessity for moving forward with the implementation of reasonable cost ceilings. Due to delays experienced in implementation of the department's conceptual model, we believe the Board should establish a timetable for implementation of the new approach.

Using a reasonable cost ceilings approach should reduce processing times for claims, department administrative costs, and claimant business costs. The reasonable cost ceilings approach should also allow for more accurate projections of expenditures and fund liabilities. Development of costs ceilings needs to be preceded by the preparation of defined corrective action tasks as outlined in Recommendation #8.

Recommendation #9

We recommend the Board, in conjunction with DEQ:

- A. Develop reasonable cost ceilings for defined corrective action tasks.**
- B. Establish a timetable for implementation.**

Management Memorandums

During the course of this audit, several issues were raised that are not addressed by formal report recommendations but warrant further management consideration, either by the Board or DEQ.

Management responded to each of these issues and outlined steps for addressing concerns noted. Memorandums addressed:

- ▶ Application process and reduced review timeframes for installation/removal permits. The department has developed new permitting application forms and procedures in consultation with UST contractors.
- ▶ Rule-defined timeframes for operating permit technical review. Current administrative rules do not define a maximum process timeframe for operating permit review. The department plans to make the necessary rule revisions by December 2003.
- ▶ Operating permit inspection cycle. The department has statutory authority to establish an inspection schedule and plans to revise its procedures following review of proposed federal legislation.
- ▶ Revising operating permit inspection report and application forms. The department is developing new operating permit documentation in consultation with the regulated community. Revised documentation will reflect updated compliance criteria and should be in place by January 2004.
- ▶ Methods for verifying additional insurance coverage and assent to audit information during the operating permit review process.
- ▶ Improvements in management information systems in the Remediation Division and coordination with the department's strategic information technology plan. The department is in the process of making improvements in Remediation Division management information systems. This effort is being

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coordinated with the development of the department's enterprise database. As part of this process, the Remediation Division's Information Services Section was merged with the department's Office of Information Technology.

Chapter V – The Future of Petrofund

Overview: This chapter discusses the differences between Petrofund and alternative fund models from other states. We recommend the Legislature outline steps to terminate Petrofund and transition to private insurance coverage.

Introduction

Petrofund was originally developed to mitigate risk the private sector was unable or unwilling to assume. Over the years, developments in other states and in the private UST insurance market have resulted in a reassessment of the benefits of tax-financed state funds. Our review of funds in other states shows there are alternative fund models available. The alternative models offer different levels of public and private sector expenditures.

Comparing Petrofund to Private Insurance Funds

One characteristic Petrofund shares with private tank insurance funds is the objective of managing liability. Private insurance funds manage liabilities to remain solvent and return a profit. Petrofund manages liabilities to remain solvent, finance cleanup, and continue as a financial assurance mechanism for owner/operators. Petrofund and private insurance firms offering coverage for release liability use several basic techniques to manage liabilities. These include: eligibility criteria, liability limits, and cost exclusions/controls. However, Petrofund lacks three features used by private insurance funds to manage liabilities:

- ▶ **Policies** – an insurance fund writes a policy for every individual risk. The underwriting process allows an insurance fund to quantify the extent of its liabilities. Petrofund does not write policies or have policyholders. Provided they meet the eligibility criteria, every tank in the state containing petroleum products is a potential liability. Without knowledge of liabilities, it is more difficult for the fund to effectively plan for the financing of future liabilities.
- ▶ **Premiums** – insurance funds accumulate reserves to offset liabilities by charging premiums. Premiums increase in proportion to risk. Owner/operators have a financial incentive (lower premiums) to upgrade tank systems and this reduces the fund's liability. Petrofund does not charge premiums. The fund

is financed through taxation and the tax is assessed at the same level regardless of the age or condition of tanks. Petrofund imposes minimum compliance standards through eligibility criteria, but lacks the ability to manage liability through price incentives.

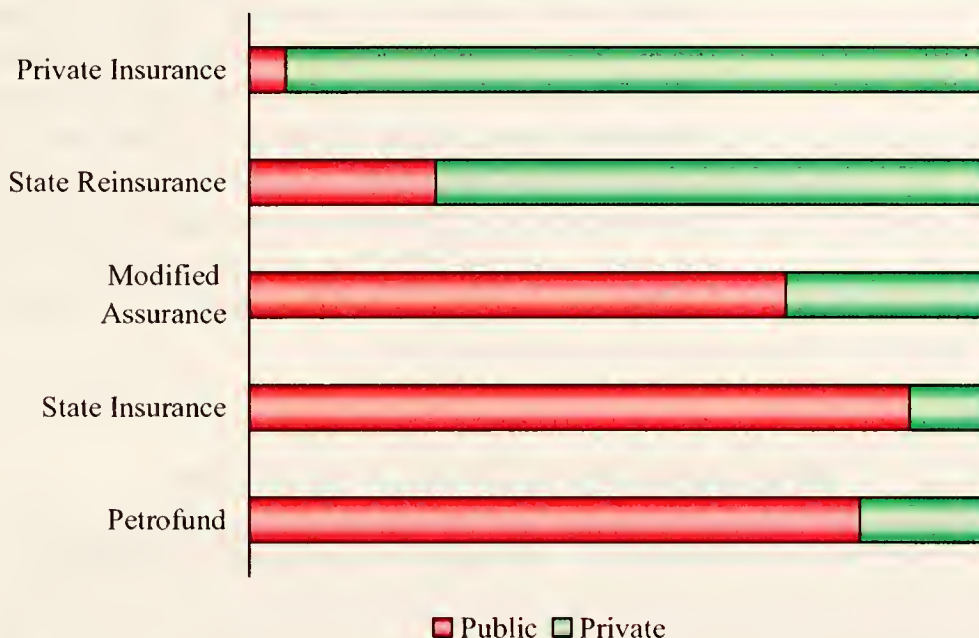
- ▶ **Pre-existing Conditions** – insurance funds exclude coverage of pre-existing contamination. Coverage is extended for releases which occurred and were reported during the term of the policy. Petrofund extends coverage to pre-existing contamination. For eligible tanks, the fund pays for cleanup regardless of when the release occurred. In many cases, cleanup will uncover and include decades-old contamination from previous releases. An insurance fund would not normally assume liability for historic releases because the liability is unquantified and unfunded.

Changing the Public/Private Balance

Funds in other states have developed or adapted to varying degrees to reflect the principles and practices of private insurance firms. We identified four alternative fund models used in other states. The effect of using these alternatives in other states has been a shift in the balance between public and private sector involvement in petroleum release cleanup. For each model, we reviewed the impact in terms of the balance between public and private sector involvement in release cleanup. Figure 10 illustrates the balance between public and private sectors for our four alternatives. The calculated values are based on public versus private expenditures for a typical release where cleanup costs are around \$100,000. For comparative purposes, similar values for Petrofund are also included.

Figure 10

Public vs. Private Involvement in Different Fund Models



Source: Compiled by the Legislative Audit Division from department records and information from other states.

The four alternative models we identified are discussed in greater detail in the following sections, including advantages and disadvantages.

Private Insurance Fund

Private insurance has not always been readily available or affordable for many tank owner/operators. Prior to the enforcement of federal upgrade requirements, many tanks were uninsurable. As private coverage became less affordable, state assurance funds filled the void. State funds provided resources to fund cleanup of existing contamination and incentives for owner/operators to upgrade their tanks to meet federal/state requirements.

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We contacted four private insurance companies offering UST insurance. Our discussions with these insurance companies showed recent trends toward expansion of coverage at a lower price, the opposite of the situation ten years ago. In addition to discussing general market trends and the products the insurance companies offered, we also asked the companies to provide an estimation of the premium charged for three typical facilities. Technical information for the three typical facilities was based on profiles developed by the department's regulatory staff. It was assumed all the facilities were inspected and are in full compliance with applicable federal/state regulations. For each facility, we requested a deductible of \$5,000 and the liability limits required by Montana law. The results of this review are shown in Table 3.

Table 3
Estimated Annual Premium Costs for Private Insurance

	Company A	Company B	Company C	Company D
<u>New Facility</u> 3 double-wall tanks	\$691	\$675	\$500-\$675	\$500
<u>Old Facility</u> 3 single-wall tanks	\$1,824	\$1,200	\$650-\$1,020	\$1,375
<u>School District</u> 1 single-wall tank	\$385	\$900*	\$500	\$500*

* Insurer's minimum site premium.

Source: Compiled by the Legislative Audit Division from information provided by insurance companies.

The cost information provided by the insurance companies was for coverage of all tanks and related components at a facility. Insurers base premium calculations on tank construction and age and this is reflected in low premiums for new facilities.

Advantages

- ▶ The state can reduce its exposure to liability by transferring all of the risk associated with some facilities to the private sector.
- ▶ Reducing the liability will allow for reduction and eventual elimination of revenue collected through taxation. It will also allow for reductions in the administrative costs of the Board and department.
- ▶ Moving away from state-funded financial assurance could encourage more insurance companies to enter the UST insurance market and promote greater price competition.
- ▶ Owner/operators with private insurance policies pay premiums based on risk. This should encourage risk-reducing behavior, decrease the number of releases occurring and ensure the protection of the state's environmental resources.
- ▶ Compared with Petrofund, private insurance funds offer policyholders more flexibility in terms of deductibles and liability limits and more responsive claims management procedures.

Disadvantages

- ▶ It will be difficult to transfer liability for some facilities. Insurance companies can offer affordable rates for UST coverage, but rates for ASTs tend to be higher. ASTs have never been regulated and can pose a greater release risk than regulated underground tanks. Any move towards private coverage would probably need to be restricted to USTs until the question of AST regulation has been addressed.
- ▶ Revenue collections would need to continue in order to fund existing liabilities and AST release cleanup and administrative costs. For UST owner/operators, this could result in additional insurance costs being incurred without any corresponding reduction in the tax burden.
- ▶ The UST insurance market is subject to the same volatility experienced for other insurance products. Premiums have been falling for some time, but they could rise again, increasing the cost of doing business for tank owner/operators.

- ▶ Owner/operators may transfer the costs of buying insurance to consumers in the form of higher prices.

Transition Strategy

For high-risk tanks (particularly ASTs), Petrofund will likely remain the primary means of demonstrating financial assurance for several years. However, the transition options below, in conjunction with improved regulation, could be applied to ASTs over a longer timeframe. For low-risk tanks (particularly those USTs meeting the 1998 upgrade requirements), a transition strategy could involve establishing a sunset date for fund eligibility. After the sunset date, tanks in the specified category would no longer be eligible for the fund. To remain in compliance with financial assurance requirements, owner/operators would need to purchase insurance. Another transition approach could involve pricing Petrofund out of the market. By increasing the deductible or co-payment, or reducing the liability limits over time, the fund would make itself less attractive as compared with private insurance funds. With premiums at low levels, decreasing the fund's liability in the event of a release would reduce its competitive advantage.

Thirteen states have established sunset dates for release eligibility or fee collection or both. Several states have already closed their funds to new business and made the transition to private provision. The market for UST insurance is growing in response to solvency problems of state assurance funds. UST insurance used to be a specialist insurance product, offered at a high price, and with stringent underwriting requirements. Finding coverage is far easier now. Most of the companies we spoke with indicated they were able to process applications in 24-48 hours.

State Reinsurance Fund

In 1990, Washington established the Pollution Liability Insurance Agency (PLIA) as a state reinsurance fund providing excess coverage for commercial USTs. Most private insurance funds purchase insurance to protect against large losses. A policy covering the losses of an insurance fund is called reinsurance. PLIA operates by acting as a reinsurance fund for three private insurance funds providing coverage for USTs in Washington. The private insurance funds are responsible for liabilities up to \$75,000 and PLIA covers

the remaining liability up to \$1 million. A private reinsurance fund covering this level of liability would charge the primary insurer a large premium and this would be reflected in high premiums for tank owner/operators. PLIA charges a low reinsurance premium and requires the transfer of savings to policyholders as premium discounts.

PLIA is financed through a 0.5 percent tax on the wholesale value of petroleum products. Since 1993, the fund has remained solvent, paid-out approximately \$14 million in cleanup costs, and generated around \$10 million in interest. PLIA covers 87 percent of the UST systems in Washington. The average annual premium in 2002 was \$1,187, down from around \$3,100 in 1990. This represents a substantial saving to owner/operators over the life of the fund. We recalculated Montana's historic reimbursements on the basis of the state providing reinsurance for liabilities over \$75,000 since 1990. Our analysis showed the amount of tax revenue expended for cleanup could have been reduced by \$22.5 million using this fund model.

PLIA does not perform any underwriting or claims management functions. The role of the state is restricted to revenue collection, fund administration, payment of excess liability, and periodic assessment/audit of the insurance funds participating in the program. Owner/operators deal directly with insurance companies when applying for coverage, paying premiums, and making claims.

Advantages

- ▶ PLIA provides low-cost insurance through an indirect subsidy on the cost of private coverage. The presence of PLIA also acts as a competitive incentive for private insurers operating in the same market.
- ▶ The state's exposure to liability is drastically reduced. The majority of liability is assumed by private insurance funds. The state's liability is restricted to the minority of releases where cleanup exceeds \$75,000. In Montana, 85 percent of releases cost less than \$75,000.

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- ▶ The revenue requirements of a reinsurance fund are likely to be lower than the state assurance or insurance models. Between 1990 and 1993, Washington collected revenues totaling around \$48 million. Montana collected around \$63 million in the same period.
- ▶ The state's administrative costs are also reduced as private insurance companies provide the staff support and other services necessary to administer the fund.

Disadvantages

- ▶ There is some doubt over the long-term viability of the reinsurance fund model due to developments in the private UST insurance market. As private insurance premiums become more competitive, the role of PLIA may become less relevant.
- ▶ Private insurers will need assurance as to the solvency of the fund proposing to cover their excess liabilities. Private insurers may be skeptical about the ability of some state funds to meet obligations.
- ▶ The reinsurance model provides an opportunity to reduce the tax burden, rather than eliminate it altogether. Although Washington's petroleum products tax has been suspended since 1993, there are plans to reintroduce it again later this year.
- ▶ PLIA does not cover administrative costs associated with the state's regulation of releases. If Montana decided to adopt a similar model, resources to fund the state's regulatory effort would need to be identified.
- ▶ PLIA does not cover aboveground tanks. Although insurance companies operating in Washington can and do write policies for ASTs, the excess liabilities are not covered by PLIA and no support is available to reduce premium costs.

Transition Strategy

In the transition to a state reinsurance fund, Montana could eliminate large sections of Petrofund statutes dealing with fund administration, and eligibility and reimbursement. Montana could also consider either reassigning functions to a department with relevant skills and experience, or establishing an independent agency to administer the fund. PLIA has no jurisdiction over disputes between insurers and policyholders, reducing the need for the involvement of a board. The most important part of any transition would be identifying insurance companies willing to participate in the program. In addition to

agreeing to reinsurance terms with private insurance funds, it would be necessary to develop administrative policies and procedures to ensure the fund functions as intended.

The state reinsurance fund model was developed in response to specific circumstances in Washington. State law did not allow public money to be used to pay for pollution cleanup. Washington had to develop a unique approach to funding petroleum release liability. Under the reinsurance fund model, state involvement is reduced to the lowest possible level. The subsidy provided by PLIA is indirect and has a less distorting effect on the private UST insurance market. Owner/operators are required to meet the underwriting requirements of the private insurance funds. Although premiums are charged at a discounted rate, they are still risk-based and they still offer incentives for risk-reducing behavior. The reinsurance fund model offers a method for taking full advantage of private sector resources, while retaining state involvement and ensuring premiums are affordable.

Modified State Assurance Fund

The modified state assurance fund model retains many of the features of the Petrofund model. This model is based on structures used by other states. State assurance funds in other states assumed different levels of liability and adjusted their fund accordingly. To see how different variables might affect Montana's fund, we recalculated compensation payments from 1990 through 2002 to reflect higher deductibles, lower liability limits, different co-pay structures and extra coverage exclusions:

- ▶ **Deductible** - if the fund's deductible had been increased from \$35,000 to \$45,000, the fund could have saved approximately \$1.7 million since 1990. If the deductible was set at \$55,000, approximate savings would have been \$3.3 million.
- ▶ **Liability Limits** - assuming a higher deductible of \$45,000, the fund could have generated savings by decreasing the liability limit from \$1 million. At \$700,000, savings could have been \$3.2 million. If the deductible was set at \$55,000, a \$700,000 liability limit could have resulted in savings of \$4 million.

Chapter V – Future of Petrofund

- ▶ **Co-payment** - most owner/operators pay 50 percent of their deductible. Using an approach from private insurance funds, we adjusted the co-pay on a sliding scale for a \$55,000 deductible and calculated approximate savings of \$5 million.
- ▶ **Exclusions** - if Montana's fund excluded third-party claims as a class of coverage, savings since 1990 could have amounted to around \$2.7 million.

Recalculation of expenditures provides an indication of how much could have been saved. Making projections of possible future savings is more difficult, but the examples above show there are options which can be explored.

Advantages

- ▶ Retaining state involvement maintains a cost subsidy for tank owner/operators which may be passed on to consumers in the form of lower prices.
- ▶ Increasing the proportion of risk assumed by owner/operators encourages compliance and reduces overall liability.
- ▶ Savings generated would improve fund solvency and result in more money being available for cleanup.
- ▶ Eliminating third-party claims would free-up resources for actual cleanup and would reduce a potentially large long-term liability to the fund.

Disadvantages

- ▶ Retaining state involvement does not allow for a reduction in the tax burden through elimination of the petroleum tank cleanup fee.
- ▶ Increasing the proportion of risk assumed by the owner/operator may discourage release reporting and could result in financial difficulties for owner/operators.
- ▶ Eliminating third-party claims would require alternative coverage to be made available if tanks are to meet financial assurance requirements.

Transition Strategy

Transitioning to this model is relatively simple because the basis is still Petrofund. Increasing the deductible or changing the co-payment would be easiest to achieve as this only involves revising statute so owner/operators pay a larger proportion of cleanup costs.

Decreasing liability limits or eliminating third-party claims would be more difficult. Owner/operators would need coverage for the excess liability which the fund no longer covers. For example, if the liability limit is decreased to \$700,000, an owner/operator would need to demonstrate ability to pay the excess liability of \$300,000 through assets or insurance.

Modifying the existing state assurance fund model would involve revision of statute and preparatory work to ensure owner/operators meet financial assurance requirements. This approach would limit the state's exposure and spread a greater proportion of risk to the private sector, but the overall effect may be limited and the state would still assume the majority of the liability.

State Insurance Fund

In 1990, the Idaho legislature established the Petroleum Storage Tank Insurance Fund (PSTIF) as a not-for-profit insurance organization. The fund is financed through a \$0.01 per gallon petroleum products tax and an annual fee paid by tank owner/operators. The fund is administered through the Idaho State Insurance Fund (workers compensation fund).

PSTIF incorporates several elements of a commercial insurance fund not normally found in the state assurance model. Tanks are covered by a written policy for individual owner/operators. The owner/operator pays an annual per tank fee of \$25. The fee is similar to a premium, although there are important differences discussed below. A deductible of \$10,000 is applied to all cleanup costs. Like most private insurance funds, PSTIF does not cover pre-existing contamination.

Advantages

- ▶ Writing specific policies for owner/operators allows the fund to quantify its liabilities. The fund only covers those tanks which have applied, and all tanks must meet underwriting requirements.
- ▶ Using a petroleum tax in addition to application fees allows the fund to maintain a cost subsidy for owner/operators which may be passed on to consumers in the form of lower prices.

Chapter V – Future of Petrofund

- ▶ Excluding pre-existing contamination reduces total fund liabilities.
- ▶ PSTIF is solvent and currently has a balance of approximately \$40 million. Fee collection has been suspended until the fund's balance drops.

Disadvantages

- ▶ It is unclear how well PSTIF has performed in comparison with other state funds. EPA data shows Idaho reported under half the number of releases compared with Montana, despite having a similar number of tanks. The healthy fiscal position of the fund may be primarily due to the lower number of releases and the lack of comprehensive cleanup parameters.
- ▶ Owner/operators pay an application fee, but this does not function as a premium. The fee is assessed at the same level regardless of tank condition. Private insurance funds assess premiums on the basis of risk, providing an incentive for risk-reducing behavior. Flat-rate fees, set at a low level, are not an effective means of spreading risk because they provide no incentives to modify behavior.
- ▶ Retaining a tax-financed fund does not allow for a reduction in the tax burden through elimination of the petroleum fee.
- ▶ Unlike the other fund models, the Idaho state insurance fund model does not allow for as much liability to be transferred to the private sector.

Transition Strategy

Transitioning to a state insurance fund model would involve substantial revision of statute, reassignment of administrative functions and the reform or elimination of the Petrofund Board. Statutes would need to be revised to incorporate the insurance functions identified above. Fund management, underwriting and claims processing functions could be reassigned to reflect the adoption of insurance principles. Idaho assigned their fund to the same organization administering the workers compensation fund; other options could include the State Auditor's Office or the Department of Commerce. Trusteeship would also have to reflect insurance principles. The trustees of Idaho's fund are not allowed to have any pecuniary interest in fund business. Either the membership or legal authority of Montana's Board would need to be altered to comply with the principle of independent trusteeship.

The state insurance fund model used in Idaho has been effective in limiting the state's exposure to liability. However, this has been achieved with minimal involvement from the private sector. PSTIF has not spread risk evenly between public and private sectors. It appears to have limited its liabilities primarily by excluding coverage for pre-existing contamination. While this approach limits the fund's liability, it does not necessarily ensure the risk is mitigated through other means.

The Future of Petrofund

Petrofund was developed in response to specific circumstances. The fund's design and operation was determined by conditions which existed before federal regulatory efforts made a significant impact on the problem of petroleum releases. Petrofund was also developed at a time when financial assurance was unavailable or unaffordable in the private sector. As we concluded in Chapter III, circumstances now are different, but the extent and direction of Petrofund activities have not changed.

What Factors are Driving Change?

At a basic level, the design of underground storage tanks has improved, reducing the risk of releases occurring. New fiberglass-reinforced plastic tanks offer better corrosion protection than older steel tanks. Automated leak detection allows for accurate tank monitoring and more timely release notification. Improvements in technology do not necessarily lessen the severity of releases, but they do ensure fewer releases occur and reduce overall liability.

Changes in relation to compliance with federal and state requirements have also reduced release occurrence and liability. Montana initiated a compliance program to ensure all tanks met federal upgrade requirements before the 1998 deadline. Compliance efforts resulted in 96 percent of tanks meeting all upgrade requirements and all USTs in the state are now subject to regular inspections. Due to the successful compliance effort, new releases are declining and appear to be stabilizing at around 50 per year. Petrofund has assumed liability for a large portion of historic contamination associated with petroleum releases.

Chapter V – Future of Petrofund

As a result of these changes, private insurance coverage is now more available and affordable than before. The market for UST insurance has been growing as changes in tank design and state compliance efforts have reduced release risk and existing contamination has been mitigated by state fund activities. Previous barriers to purchasing UST insurance no longer exist. The premium estimates provided by insurance firms show how far the cost of coverage has fallen.

Statutory Guidance Supports Change

We identified two areas of statute which provide guidance for addressing these changing circumstances. The first area relates directly to Petrofund. The second relates to legislative review of state government programs in a general sense:

- ▶ In relation to the establishment of Petrofund, section 75-11-301 (3), MCA, refers to the need for a fund to address ‘current’ problems which the public and private sectors could not address due to inadequate resources. If adequate financial and administrative resources do exist in the private sector, we interpret statute to mean the existence of Petrofund no longer meets legislative intent. Alternatives to Petrofund do exist. Administrative rules (17.56.807 ARM to 17.56.811 ARM) define a variety of allowable financial assurance mechanisms which can be used instead of Petrofund.
- ▶ Section 2-8-101, MCA, addresses the growth of state government agencies and need for periodic evaluations of programs to determine if they should be terminated, modified or re-established. In addition, section 2-8-304(1), MCA, requires the legislative auditor to present information on state government functions which can be performed more cost-effectively by the private sector.

When viewed together, we believe these statutes constitute a sufficient basis for legislative consideration of eventual termination of Petrofund and a transition to private sector insurance coverage.

Petrofund Costs and the Benefits of Change

Continuation of Petrofund as a tax-financed financial assurance mechanism has several negative consequences. The following sections outline the costs associated with maintaining the current level of public involvement in release cleanup, and contrast these with the benefits of shifting the balance towards the private sector.

State Liability

The state has already assumed liability for ongoing cleanup costs for approximately 740 unresolved releases. It is probable this liability will amount to tens of millions of dollars and may be as high as \$50 million. If Montana required tank owner/operators to purchase private UST insurance, the state would be released from any future financial obligations resulting from new releases. Both the private insurance model and the reinsurance model would provide a means of transferring future liability either in whole or in part to the private sector. The modified assurance fund model and the state insurance model either retain or increase the state's share of liability.

Tax Burden

Petrofund liabilities must be paid for using tax revenue derived from the petroleum storage tank cleanup fee. The fee was originally set at \$0.75 per gallon and has remained unchanged at this level. As long as the state continues to assume liability, collection of the cleanup fee will be necessary. Transferring liabilities to the private sector would allow for the gradual reduction and eventual elimination of the tax burden resulting from financing release cleanup. The private insurance fund model is the only option which allows for the elimination of the fee. The remaining fund models allow for reductions or temporary suspension of fee collection, but all rely on a permanent source of tax revenue.

Administrative Costs

Continuation of Petrofund also imposes costs for administration of fund functions, including Board activities, and the department's compliance, cleanup, and compensation functions. Administrative costs are approximately \$1.4 million annually. The private insurance and reinsurance models offer the best opportunities for reducing administrative costs. The private insurance model reduces administrative costs by transferring them to private insurance companies. In the reinsurance model, where private sector insurers perform underwriting and claims management tasks, state administrative resources are not required to fulfill these functions. The Washington PLIA devotes around 4-5 FTE to its commercial UST program. This is less than Petrofund's staff allocation, even though Washington has three times the number of tanks. The

Chapter V – Future of Petrofund

modified state assurance fund and state insurance fund models retain state government staff and other resources at levels which do not allow for significant reductions in administrative costs.

Private Sector Development

Both private UST insurers and tank owner/operators could benefit from termination of Petrofund. Discussions with private UST insurers indicated they have minimal market presence in states where state funds continue to operate. Private insurers cannot compete on price with a state fund financed through taxation. As more states make the transition to private coverage, the UST insurance market has seen new entrants, increasing competition and lower premiums. Although tank owner/operators would need to pay premiums for private coverage, they would gain in terms of the flexibility offered by private insurers as compared with Petrofund. Private UST insurers offer a wide variety of deductible levels and liability limits to suit the individual needs of businesses. The modified state assurance fund and state insurance fund models can be adapted to offer greater flexibility to owner/operators, but neither offers opportunities for developing the market for private UST insurance. The private insurance fund and reinsurance fund models should allow developments in both areas.

Making the Transition

Seven other states have already completed the transition to private insurance coverage or an alternative financial assurance mechanism in place of a state fund. An additional thirteen other states established sunset dates for some aspect of their fund operations. Circumstances have changed since the early 1990s when state-sponsored financial assurance was the only option. We believe the Legislature should outline the steps to transition from Petrofund to private insurance coverage. We believe tank owner/operators will find private insurance coverage the most suitable replacement for Petrofund, but statute should continue to recognize other appropriate alternative financial assurance mechanisms. The timeframe for transition should be determined by the extent of Petrofund's existing liabilities. It is probable tax revenues will be required for 10 to 15 years to fund these liabilities. We also believe the legislature should consider options which will ease the transition into full private

coverage, including an interim reinsurance/excess coverage program. By providing reinsurance for private UST insurers, the state can help to promote the development of a competitive market, while mitigating the impact of new premium costs for tank owner/operators.

Recommendation #10

We recommend the legislature outline steps to transition Petrofund coverage to private insurers by:

- A. Requiring all owner/operators installing new tank systems to purchase private insurance or provide proof of financial assurance other than Petrofund.**
- B. Phasing-in private insurance coverage or alternative financial assurance for owner/operators of tanks meeting all the 1998 upgrade requirements.**
- C. Phasing-in private insurance coverage or alternative financial assurance for owner/operators of all remaining underground and aboveground petroleum storage tanks and terminating Petrofund.**
- D. If necessary, developing interim transition incentives for owner/operators, including a reinsurance/excess coverage program to mitigate the initial effects of insurance premiums.**

Appendix A - Audit Approach

Audit Scope

To establish audit scope, we met with department and Board officials to discuss fund operations. Discussions were held with Board members as well as the regulated community to identify key areas for consideration. We coordinated our audit planning and fieldwork with Legislative Audit Division financial-compliance auditors to avoid duplication and take advantage of previous audit work. As a result of these discussions and our audit planning, we found topics highlighted by the audit committee and department officials warranted further review.

The central objective for this performance audit was to establish how operations and procedures of involved entities affect fund solvency. Audit work focused on issues related to cost control (eligibility, corrective action costs, etc.). We also considered areas such as compliance oversight, which indirectly impact fund solvency. Some issues were excluded from our audit scope such as compliance with the Montana Environmental Protection Act, Water Quality Act and other environmental legislation not directly relating to UST and petroleum release regulation. In addition, we excluded review of the scientific standards and remediation methodology applied by DEQ when managing releases, and the contractor licensing program.

Unless otherwise stated, audit work focused on the four calendar years from January 1999 to December 2002. Several factors were important when selecting the period for audit: December 1998 was the final Environmental Protection Agency (EPA) deadline for UST system upgrades, current program organization reflects substantial changes made during the 1999 Legislative Session, and a four-year audit period provides sufficient populations and data for effective, statistically valid and manageable file review and analysis procedures. Where financial data is used, we compiled summary-level information for the period FY 1990 to FY 1999. Additional, detailed financial data was obtained for FY 2000 to FY 2003.

In addition, we examined the performance audit report issued by the Legislative Audit Division in December 1996, Petroleum Storage Tank Release Cleanup Activities (96P-03) to identify the mission

Appendix A - Audit Approach

and issues relevant at that time. Although the 1996 audit identified concerns relating to fund solvency and accurately projected the downward trajectory of the fund balance, there was insufficient information at that point to base conclusions regarding underlying fund management issues. Statutory revisions introduced during the 1999 Legislative Session resulted in alterations in the organizational structure of the program.

Audit Methodologies

In response to our audit objectives the following audit methodologies were completed.

Board Activities

Board meetings were observed and interviews were conducted with Board members, staff, and other interested parties during audit planning, fieldwork, and report development. Board minutes for the past four years (1999 thru 2003) were examined. We examined fund eligibility and reimbursement procedures followed by the Board in a statistical sample of 61 files. This sample was randomly selected from a population of 142 fund-eligible releases occurring between January 1, 1999 and December 31, 2002. These releases were found eligible for PTRCF reimbursement and had received at least one payment. In addition to the eligibility determination activities documented in these files, we also examined 379 claims for reimbursement.

DEQ Activities

Interviews were conducted with department regulatory staff as well as management personnel. DEQ permitting activities were examined through file reviews. File reviews were completed by randomly selecting a statistical sample from program activities including:

- ▶ Twenty installation and removal permit files to identify operational procedures.
- ▶ Fifty-eight operating permit files covering inspection activities, department review, and permit issuance.
- ▶ The same 61 files used to examine Board activities were also used to highlight DEQ actions for release corrective action, eligibility, and fund compensation. We reviewed 115 corrective action plans.

Staff site visits and inspections were observed. Program planning and management were documented and discussed throughout the audit. Program documentation at DEQ regional offices was also examined. Management information systems were identified and data was extracted for our analysis. Staff meetings and meetings with industry representatives were observed.

General Activities

To obtain the perspective of the regulated community, we surveyed 150 contractors and consultants. Program statutes/rules, statistics, and documentation were compiled. Forms used and procedures followed were documented. Statutory and rule changes in the past four years were examined.

Data from other states and private insurance companies was gathered. Technical guidance documents from the EPA were reviewed. Release sites and tank facilities, both UST and above ground tanks, were visited. Applicable federal regulations (40CFR, Parts 280 and 281) were reviewed. Legal opinions from internal legal staff and department legal staff were examined. Website information on various state and federal programs/activities was compiled.

General background data on underground tank activities in Montana was gathered including number of tanks, number in operation, tank characteristics, average number of tanks per facility, statewide distribution patterns, and compliance history.

Fund revenues and expenditures were compiled and analyzed to identify trends and fluctuations. Fund revenue information and collection/distribution procedures were discussed with Montana Department of Transportation personnel.

Compliance

We examined compliance with state law and administrative rules relevant to the PTRCF program. Montana statute relating to the regulation of USTs and the operation of the PTRCF are contained in Montana Code Annotated, Title 75 (Environmental Protection), Chapter 11 (Underground Storage Tanks), Parts 2, 3 and 5. The

Appendix A - Audit Approach

PTRCF Board is established under section 2-15-2108, MCA, which also sets out the representative interests of Board appointees. Audit discussions of potential noncompliance are discussed in Chapters II, III, and IV.

Appendix B – Issues For Further Study

Issues for Further Study

We identified two areas within DEQ as potential issues for future audit. The following sections discuss these areas and the related concerns.

LUST Program

The Leaking Underground Storage Tank (LUST) program is a federally funded program undertaking cleanup of releases where a responsible party cannot be identified or is unwilling or unable to pay. Montana's LUST program receives annual grants from the federal LUST Trust Fund. Grants are used to fund FTE in the Remediation Division and to pay for cleanup at around 85 release sites.

Further study in relation to the LUST program could include general program efficiency and effectiveness, coordination of cleanup efforts with state-funded programs, contracting procedures for LUST-funded cleanup, and the applicability of LUST program direct contracting arrangements to Petrofund releases.

Petroleum Storage Tanks and the Uniform Fire Code

Our audit work showed a minimal number of UST facilities are being regularly inspected for compliance with the Uniform Fire Code (UFC). The Fire Prevention and Investigation Bureau (FPIB) has regulatory authority over facilities where USTs contain petroleum products, but inspections appear to be limited to dual-use facilities (gas stations which have a casino or restaurant attached). Petroleum products stored in underground or aboveground tanks present a major fire and explosion risk, yet facilities appear to be subject to a low level of oversight. Further study could address the applicability of UFC rules to petroleum storage tanks, the resources available to the FPIB for conducting inspections, or alternative methods for ensuring tanks receive regular inspections for fire safety purposes.

Board and Department Response

MONTANA PTRC
Petroleum Tank Release Compensation
P.O. Box 200902 Helena, MT 59620-0901 (406) 444-0925

October 31, 2003

Scott Seacat
Legislative Audit Division
Room 160, State Capitol
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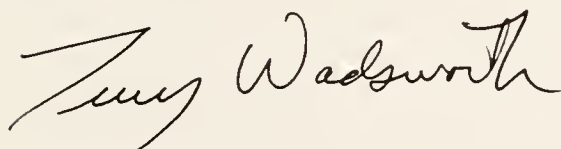
RE: Legislative Performance Audit 02P-09

Dear Scott,

This letter is in response to the Legislative Audit Division's November 2003 Performance Audit report (02P-09) to the Legislature regarding The Petroleum Tank Release Compensation Fund. Attached are responses to the recommendations made by the audit committee and members of the audit staff. The Petroleum Tank Release Compensation (Petro) Board feels that the findings of the Performance Audit are generally accurate and identified those issues that need to be addressed by both the Petro Board and DEQ. The Board also feels that many of the recommendations of the Performance Audit should be adopted, some should be evaluated, and if feasible, implemented when and where possible. While some of the recommendations can be implemented at the Board and staff level many of the recommendations will take statutory change.

If you have any questions concerning the attached responses, please contact me directly at 444-6776.

Sincerely,



Terry Wadsworth
Executive Director
Petroleum Tank Release Compensation

Attachment

Performance Audit Report Response Petroleum Tank Release Compensation Fund

By The Petroleum Tank Release Compensation Board

Recommendation #1

We Recommend the Board adopt a proactive approach to management of the fund liabilities by seeking statutory authority to revise its role to include analysis of fund activity and review of the fund's exposure to liabilities.

Response

The PTRCB is adopting a proactive role in fund liability management through hiring its own staff (as established by the passage of HB 368) and pursuing alternatives for managing liabilities. The hiring of its own staff has included the acquisition of an Executive Director who will assist the Board with fund administration, fund eligibility and compensation determination, the assignment of fund resources for department cleanup and compensation functions, designating staff responsibilities, improving appeals documentation, analyzing fund activity, assessing exposure liabilities, assisting in determining long-term fund management strategies, and pursuing rule adoption to administer the program. The Executive Director position expands the Boards expertise by providing a resource with experience in environmental assessment, environmental remediation methods and technologies, environmental consulting, environmental litigation, state government, financial analysis, budgeting, and financial planning.

Recommendation #2

We recommend the Board seek legislation to increase membership by including a representative with environmental regulatory experience.

Response

The PTRCB agrees with this recommendation. It would likely provide insights relating to the impact of regulatory activities and promote fund solvency. Although the Board is not required to consist of an odd number of voting members it is however generally consider a good practice. The Board will examine the option of including an additional member and weight the potential problems associated with an even number of voting board members. In the event that the board feels that the benefits of including a member with environmental regulatory experience outweigh any potential problems, the Board will seek legislation to revise section 2-15-21(08), MCA to including a representative with environmental regulatory experience in the 59th legislative session.

Recommendation #3

We recommend the Board direct staff to conduct analyses and make recommendation on fund management issues including, but not limited to, the following:

Performance Audit Report Response Petroleum Tank Release Compensation Fund

By The Petroleum Tank Release Compensation Board

- A. Future fund liability projections and methodology.
- B. Site prioritization and closure
- C. Regulation and financial assurance for above ground storage tanks

Response

The PTRCB agrees that analyses should be conducted and fund management strategies should be examined. The DEQ is the technical constituent, whereas the PTRCB is the fiscal constituent of the relationship. Some of the issues raised are under the control of the DEQ and their regulatory authority. The PTRCB is willing to direct staff to work with the DEQ in an effort to obtain suitable data for analysis and to address fund management issues. The PTRCB is aware that the DEQ is working on a Risk Based Corrective Action decision making process and site closure criteria. It is anticipated that a RBCA approach will favorably influence the fund. In addition, the PTRCB is aware that the DEQ is working on standard report formats and standard CAP requirements which are intended to streamline the process. This activity will provide standards useful for conducting analysis.

Recommendation #4

We recommend the Board document the evidence considered and reasons for decisions relating to fund eligibility appeals.

Response

The PTRCB agrees with this recommendation and is examining existing document tracking and management activities, claims processing and management, and document management strategies in an effort to establish a system which can easily locate documents for a particular case or issue and prepare chronologies, case prep binders, activity logs, case indexes, and culling reports.

Recommendation #5

We recommend the Board designate fund eligibility review and notification to Board Staff.

Response

Performance Audit Report Response Petroleum Tank Release Compensation Fund

By The Petroleum Tank Release Compensation Board

The PTRCB agrees with this recommendation, has hired it's own staff and has designated that staff to have the lead role in the review and determination of eligibility. The staff has been instructed to minimize the department involvement in eligibility determination and in the event that department's involvement is found to be necessary, they are to retain control of the eligibility determination by requesting a time to address the issue. The PTRCB is examining activities, processes, procedures, and roles, to further clarify and re-assign Petrofund responsibilities.

Recommendation #6

We recommend the Department designate the following responsibilities:

- A. Cleanup review, approval and monitoring to a single department.
- B. Compensation processing to the departments office of Financial Services
- C. UST permitting and compliance responsibilities to the department's permitting and Compliance Division.

Response

The PTRCB concurs with this recommendation. As mentioned in Chapter IV of the Audit report, the PTRCB is examining staff needs in response to recent legislation and is incorporating the recommendation into the process. The PTRCB would request the Department entity notify the PTRCB staff in the event of a statutory infringement *that affects eligibility*.

Recommendation #7

We recommend the department strengthen compliance procedures by:

- A. Seeking legislation revising section 75-11-203(6) MCA, to clarify the department's authority to exclude low-risk activities from UST permitting.
- B. Targeting the use of environmental assessment questionnaires during UST permitting.
- C. Assuring department oversight of operating permit inspectors occurs at least once during a three-year operating permit inspection cycle.
- D. Compiling fire safety compliance information as part of a three-year inspection cycle to reduce eligibility processing time frames.

Performance Audit Report Response Petroleum Tank Release Compensation Fund

By The Petroleum Tank Release Compensation Board

Response

The PTRCB concurs with this recommendation to be addressed by the department.

Recommendation #8

We recommend the department strengthen corrective action procedures by:

- A. Defining corrective action tasks.
- B. Standardized plan formats.
- C. Determining when a corrective action plan is warranted
- D. Establishing formal corrective action plan amendment procedures

Response

The PTRCB concurs with this recommendation to be addressed by the department.

Recommendation #9

We recommend the Board, in conjunction with DEQ:

- A. Develop reasonable cost ceilings for defined corrective action tasks.
- B. Establish a timetable for implementation

Response

The PTRCB agrees with this recommendation and is willing to coordinate with the department in defining corrective action tasks. The department has established some and was in the process of establishing other cost ceilings associated with individual invoice items. The PTRCB will continue to use the individual cost ceilings until corrective action tasks and unit cost associated with those tasks can be established. The PTRCB plans to use the individual cost ceilings along with unit cost estimates for defined cleanup tasks from other states in the development of unit cost ceilings. The PTRCB will pursue the establishment of timetables with the department for defining corrective action tasks and work to establish cost ceilings coterminous with corrective action tasks definition.

Performance Audit Report Response Petroleum Tank Release Compensation Fund

By The Petroleum Tank Release Compensation Board

Recommendation #10

We recommend the legislature outline steps to transition Petrofund coverage to private insurers by:

- A. Requiring all owner/operators installing new tank systems to purchase private insurance or provide proof of financial assurance other than Petrofund.
- B. Phasing-in private insurance coverage or other alternative financial assurance for owner/operators of tanks meeting all the 1998 upgrade requirements.
- C. Phasing-in private insurance coverage or other alternative financial assurance for owner/operators of all remaining underground and above ground storage tanks and terminating Petrofund.
- D. If necessary, developing interim transition incentives for owner/operators, including a reinsurance/excess coverage program to mitigate the initial effects of insurance premiums.

Response

The Board presently believes that the Petro Fund continues to serve the State of Montana and its statutory goals. However given the current monetary status of the Petro Fund and the findings of the recent audits, the Board agrees that its role and the overall direction of Petro Fund need to be revised, that analysis should be conducted and fund strategies and goals should be examined. The PTRCB is willing to direct staff to work with the legislature to study Private Insurance approaches and owner/operator needs in an effort to evaluate this recommendation as to its merits and make a determination at a future point.



Montana Department of
ENVIRONMENTAL QUALITY

Judy Martz, Governor

P.O. Box 200901 • Helena, MT 59620-0901 • (406) 444-2544 • Website: www.deq.state.mt.us

November 4, 2003

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LEGISLATIVE AUDIT DIV.

Angie Grove
Performance Audit Manager
Legislative Audit Division
Room 160, State Capitol
Helena, MT 59620-1705

Dear Ms. Grove:

Thank you for the draft final report of the performance audit of the Petroleum Tank Release Compensation Fund (PTRCF). With this letter, the department is responding in detail to those audit recommendations that apply to us. We have reviewed the audit in its entirety, including those recommendations directed to the PTRCF Board (the board), and we concur with those recommendations. We will assist the board however we can in helping to implement those recommendations.

I would like to take this opportunity to thank and compliment you, Tom Cooper and Angus Maciver for the professional manner in which this audit was conducted. You have been thorough and fair in assessing strengths and weaknesses of this program and in offering recommendations.

As you stated in your letter of October 8, recommendations 6, 7, 8 and 9 apply to the department. Our responses to those recommendations are attached. In addition, while recommendation #3 is directed to the board, part B of that recommendation deals with site prioritization and closure, which are both financial and technical issues and thus will involve the department as well as the board. Because of this, we have briefly addressed recommendation 3.B also.

Again, thank you for the thoroughness and professionalism of this audit. The department looks forward to working with the PTRCF board and its staff in implementing the recommendations contained in the audit.

Sincerely,

Jan P. Sensibaugh
Director

Enc: DEQ RESPONSE
Cc: Barry Johnston, Chair, PTRCB
Terry Wadsworth, Executive Director, PTRCB

DEQ RESPONSE
PERFORMANCE AUDIT OF NOVEMBER 2003
Petroleum Tank Release Compensation Fund (PTRCF)

Recommendation #3

We recommend the board direct staff to conduct analyses and make recommendations on fund management issues including, but not limited to, the following:

B. Site prioritization and closure.

The department will continue its work developing site prioritization and closure procedures. Prioritization will be based primarily on environmental and health risks. As these procedures are developed, the board can then utilize the information to guide fund management decisions.

Recommendation #6

We recommend the department designate the following responsibilities:

A. Cleanup review, approval and monitoring to a single department entity.

The department concurs with this recommendation, and it has been implemented. The recommendation was driven by a need to delineate and separate the functions of cost approval and environmental cleanup requirements. At the time of the audit, both functions were the responsibility of the department.

The 2003 Legislature passed HB 368, which transferred the claims review and approval function from the department to the Petroleum Tank Release Compensation Board (the board). This law became effective October 1, 2003. This transfer, which was accomplished October 1, creates the separation recommended by the audit. Unless requested on a site-specific basis by the board, the department now has no cost review and approval authority for claims reimbursement. The responsibility for cleanup review, approval and monitoring remains with the department, and is assigned to the Petroleum Release Section in the department's Remediation Division.

B. Compensation processing to the department's Office of Financial Services.

The department concurs with this recommendation. As stated above, the claims review and approval function has transferred to the board. The department's Office of Financial Services supports the board staff in processing approved claims for Petroleum Fund reimbursement.

C. UST permitting and compliance responsibilities to the department's Permitting and Compliance Division.

The department concurs with this recommendation and is in the process of implementing it. By the end of calendar year 2003, the section responsible for underground storage tank permitting and compliance, currently located within the department's Remediation Division, will become

part of a bureau within the department's Permitting and Compliance Division that also includes regulatory activities pertaining to solid and hazardous waste and asbestos. These activities share common functions and regulatory goals of containment, and requirements for specific handling and disposal of petroleum and waste materials.

Recommendation # 7

We recommend the department strengthen compliance procedures by:

- A. Seeking legislation revising section 75-11-203 (6), MCA, to clarify the department's authority to exclude low-risk activities from UST permitting.**

The department concurs with this recommendation. During the Executive Planning Process beginning in the spring of 2004, the department will propose legislation to amend Chapter 75, Title 11, Part 2 to clarify the department's authority to exclude low-risk activities from UST permitting.

- B. Targeting the use of environmental assessment questionnaires during UST permitting.**

The department concurs with this recommendation. Department staff is working in conjunction with the regulated community to revise the permitting process. These revisions include broadening the use of existing categorical exclusions available under MEPA, which should substantially reduce the number of questionnaires submitted while still meeting MEPA requirements.

The department also is revising permitting procedures with input from the regulated community. The above revisions involving environmental assessment questionnaires are being integrated into the appropriate application forms; the department plans to complete this by winter of 2004.

- C. Assuring department oversight of operating permit inspectors occurs at least once during a three-year operating permit inspection cycle.**

The department concurs with this recommendation. As noted in the final audit, the department has increased its oversight inspection schedule and as of October 1, 2003, completed oversight inspections for all 36 licensed inspectors. The department will implement an annual schedule to ensure this continues routinely so that each inspector continues to receive an oversight inspection at least once during the three-year cycle.

- D. Compiling fire safety compliance information as part of the three-year inspection cycle to reduce eligibility processing time frames.**

The department concurs with this recommendation in concept and is investigating how best to implement it. With the passage of HB 368 in the 2003 Legislature, Petroleum Fund eligibility became aligned with underground storage tank license requirements. These license requirements do not include fire code provisions. Thus, it appears the board may no longer have authority to

require compliance with certain fire code provisions as a condition of eligibility for underground storage tanks. The board could continue to require these provisions as a condition of eligibility for above ground tanks. Since the department has no licensing authority for those tanks, HB 368 does not apply in that case. Because the department has no regulatory authority for above ground tanks, our staff does not regularly visit those facilities, and the value of this recommendation is substantially reduced.

The department will work with the board to determine whether the board agrees with the above interpretation of HB 368, and to determine what impact this will have on fund eligibility. We also will work with the Fire Prevention Investigation Bureau within the Department of Justice to examine potential database solutions to determine whether the board staff might be able to directly access relevant information from the Department of Justice database to more readily obtain whatever information is available for the provisions related to fund eligibility.

Recommendation #8

We recommend the department strengthen corrective action procedures by:

A. Defining corrective action tasks.

The department concurs with this recommendation and is working to develop a standard set of task names and associated definitions for similar recurring tasks used in the petroleum cleanup industry. A preliminary draft has been shared with the board and the industry, and the department expects to finalize the proposal this winter as it works with board staff towards the completion of a reasonable cost ceiling document.

B. Standardizing plan formats.

The department concurs with this recommendation. The department currently is using standardized formats in the remedial investigation stage. The audit recommends other activities also be standardized, where practical, to further facilitate cleanup and closure. The department is developing standardized work plan formats for other types of activity typically completed at petroleum release sites. As these standardized formats are developed, the department will work with the regulated community and the board to refine them to ensure their workability. We expect this to be completed and in place by spring of 2004.

C. Determining when a corrective action plan is warranted.

The department concurs with this recommendation. The department currently has procedures in place to conduct limited soil removal (up to 100 cubic yards) at sites undergoing tank removal with a simple written approval from the department. The department has consistently authorized the removal of contaminated soil without submission of a formal work plan under this procedure. The department will examine additional opportunities for such procedures, and will use the existing environmental risk assessments conducted for all releases as the basis for developing a risk-based approach to corrective action plans. The department will have a draft rule developed by winter of 2004, and expects to complete rule adoption by spring 2005.

D. Establishing formal corrective action plan amendment procedures.

The department concurs with this recommendation. The department and board staffs have proposed a joint process to the board after discussions with members of the industry. This process includes a single form to amend both the scope of work, approved by the department, and the budget, approved by board staff. This process has been successful in a pilot test, and the department has adopted and distributed the form for use in tracking work plan changes.

Recommendation #9

We recommend the Board, in conjunction with DEQ:

A. Develop reasonable cost ceilings for defined corrective action tasks.

B. Establish a timetable for implementation.

The department concurs with this recommendation. The department has developed an initial proposal of reasonable cost guidelines. While the board may choose a different approach or format than that outlined in the department proposal, the work already done by the department should offer the board staff a considerable head start in implementing this recommendation. Additionally, the department has identified standardized work plans and reports that would be essential to the implementation of this recommendation. The department will offer full support to the board and its staff in implementing this recommendation.

